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THE UNIVERSITY OF ALBERTA

POLITICS, PUBLIC DEBT, AND DEBT MANAGEMENT

by

ROBERT LAURENCE ASCAH

A THESIS

SUBMITTED TO THE FACULTY OF GRADUATE STUDIES AND RESEARCH

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ABSTRACT

This dissertation explores the "other side" of government revenue raising- debt management during the 1930-1952 period at the federal level. The study describes the process of debt management by initially exploring two theories of the public debt- a "burden" view and secondly, a "benign" view that the public debt is a "national blessing". This examination includes a review of the writings of Canadian academics, bankers, and officials. During the period under study there gradually evolved in academic and official circles a benign view based primarily on Keynes' macro-economic theory.

The chapter following provides economic data illustrating the evolving economic climate in which this vital governmental activity was conducted. Chapter IV reviews the politicians' attitudes to public debts, in particular, and public finance, in general. Although the politicians' influence was minimal, it is clear that the principal "third parties", the C.C.F. and the Social Credit played a minor role in this activity by pressing for a general lowering of rates in the Depression and during the war. The Liberals, unlike the Conservatives (who held a classical, burden view of the debt), tended to be more flexible and pragmatic in managing the public finances. This pragmatism is also reflected in the Liberal Government's penchant to raise or maintain taxes soon after being elected and to raise spending and/or lower taxes immediately prior to an election.

The empirical core of the study is based on research conducted at the Public Archives of Canada, the Bank of Canada Archives, and The Bank of Nova Scotia Archives. This historical review highlights the evolution of new institutions in the area of public finance and debt management. From an administrative point of view, it is clear that interest cost minimization was the primary objective at this time and was pursued with varying degrees of success. Other subordinate goals pursued included democraticizing the debt holdings and lengthening the term to maturity of the debt. The main obstacles faced included the form of the debt, the position of the chartered banks early in this period as the major holders of maturing bonds, and market forces emanating from New York putting upward pressure on Canadian rates.

Subsequent chapters explore the relations between the debt manager and chartered banks, investment dealers, and international capital. Their behaviour conforms very closely with that predicted by economic models of self-interest and models of

interest group behaviour. The study also found that during this period, these institutions had some general influence on the behaviour of debt manangers through the intermediation of the capital markets. This was evident in the examination of the Alberta crisis discussed throughout the study. The thesis also demonstrated that the establishment of the Bank of Canada in 1935 fundamentally and permanently altered the relationship between the chartered banks and the Dominion.

The relationship between an aberrant state debtor, the Province of Alberta and the chartered banks illustrated the profound concern felt by institutions holding fixed income claims threatened with default. This episode lends support for the theoretical propositions advanced concerning the nature of public debts documenting how the Dominion, the banks, and international capital responded to the Social Credit contagion.

ACKNOWLEDGEMENTS

Over the course of the past two years, I have issued a number of non-financial "I.O.U.'s" which should be reimbursed, at least in part. The pleasant time spent while researching this topic in Ottawa during the winter and summer of 1982 was made all the more enjoyable and worthwhile by the help of the staff at the Bank of Canada Archives. In particular, Mrs. Jane Witty, the Bank's archivist was unstinting in her help and co-operation, and, in addition, meticulously checked the references to materials deposited at the Bank's Archives. I am indebted as well to two former officials of the Bank, Mr. R.B. McKibbin and Mr. George Watts who shared with me their enthusiasm, insights, and knowledge concerning the activities of the central bank in its formative years. At this time, I also had the pleasure of meeting and discussing my project with Dr. J.A. Galbraith formerly with McGill University and presently an official with the Treasury Board. Dr. Galbraith was a great source of encouragement and was always helpful in advising me which individuals could be of assistance in probing the debt management process.

While in Toronto, my research was helped along by the wonderful staff at The Bank of Nova Scotia Archives under the direction of Mrs. Jane Nokes. Her staff gave me access to the wealth of C.B.A. materials relating to Dominion of Canada borrowings and the "Alberta situation". Both Mrs. Nokes and Ms. Garron Wells were exceedingly co-operative, especially Ms. Wells who had the exacting chore of ensuring my citations were accurate and complete. Across the street from The Bank of Nova Scotia, I was able to tap the reminiscences of Mr. Nigel Gunn of Bell, Gouinlock. Mr. Gunn was a fount of information on the crisis of public finance and western debts during the Depression.

Back in Edmonton, the remarkable memory of Mr. Alf Hooke gave me a greater understanding of the period from a unique Alberta perspective. I am most grateful to my dissertation committee, Professors Garth Stevenson, Bob Gilsdorf, Maureen Molot, Mike Percy, and Allan Tupper for their comments and criticisms. A special note of thanks is due to my supervisor, Professor Garth Stevenson who was readily available to discuss the progress of my work and swift in returning my drafts with his comments. Dr. Percy's comments and criticisms were always to the point even when I occasionally disagreed with him or failed to fathom his arguments. Needless to say, any errors of fact or interpretation are the author's alone.

Finally, my largest debts are owed by sister, Kathryn Ruddy and my mother, Doris Ascah, without whose support this project could not have been completed successfully.

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I. INTRODUCTION

The Context and Problematic

In November 1976, the Auditor General of Canada shocked many Canadians by declaring that, in his view, "Parliament– and indeed the Government– has lost, or is close to losing, effective control of the public purse."[1] Parliament's watchdog argued forcefully that taxpayers' moneys must be treated as trust funds and denounced what he perceived as an absence of restraint and prudence in the management of public funds.[2] Subsequently, the Royal Commission on Financial Management and Accountability confirmed many of the Auditor General's observations, noting:

> The apparently unexpected slide toward increasing deficits in both the internal accounts of the federal government and the external accounts of Canada's transactions with other countries is symptomatic of the deeply rooted problems confronting us as a nation. The single most important measure of those problems, however, is not the government's prospective cash deficit for the current fiscal year of $12 billion or more, a sum that amounts to at least one–quarter of the government's total projected expenditures for the year, *but rather that it was unplanned and unexpected in the sense that it would not have been part of the long-term plan, had there been one.* Nevertheless, the deficit currently being incurred on a National Accounts basis is not only the largest ever experienced in our peacetime history, both absolutely and relatively, but in relation to gross national product is almost twice as large as that of the U.S. federal government.[3]

This study is not concerned with the absence of a fiscal plan or the profligacy of governments. Rather the focus will be on the "other half" of governmental revenue raising, that is to say, government borrowing and the overall management of this activity.

Increasingly, the public at large and the investment community, in particular, have become alarmed at the size of the federal government's deficit. While it is true that recent deficits are post–war highs, to what extent are these deficiencies in revenue merely the product of the recession or depression? Further, should the public be worried when, in

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[1] *Annual Report of the Auditor General of Canada to the House of Commons for the fiscal year ending March 31, 1976*, (Ottawa: November 1976), p. 9.
[2] *Ibid*, pp. 10–12.
[3] *Final Report*, (Ottawa: March 1979), pp. 14–15. (emphasis added) This quotation echoes, in large measure, the following exerpt from the 1976 Auditor General's Report.
"I believe that Parliament and the people of Canada *have the right to sound information on planned and actual expenditures* and that the Government cannot afford the risk of being misled by the lack of adequate and objective information. *It is one thing to choose a course of action for reasons of public policy, knowing that it is neither the most economical nor the most efficient. It is another thing not to have complete and reliable information on which to base a decision.* The latter is something no Government can afford." p. 30. (emphasis added)

effect, the bulk of the federal debt is domestically held? Or, put differently, as "we owe it to ourselves" why should we be concerned as our children will inherit both our debts and our assets. And yet, there are those who argue that public debts postpone current costs of operation and pass forward to posterity, unto future generations, the burden of current indebtedness.[4] The problem restated in this fashion leads to the question: to what extent can governments effectively disguise from their population the actual costs of government by borrowing and hence postpone indefinitely that vaunted "day of reckoning"?

At present, much ink is being spilled by economists and officials about a so-called "structural deficit". According to this theory, a structural deficit is incurred when the economy is labouring well below capacity. As a result, government expenditures on unemployment insurance and welfare rise while government tax receipts fall causing the deficit to widen. Indeed, two economists have calculated that today's $25 to $30 billion deficit, when adjusted for unemployment and inflation, is actually a $6 billion surplus![5] This explanation, more properly termed rationalization for the failure of Keynesian inspired economic policy-making, was apparent in the document *The Federal Deficit in Perspective* tabled by Finance Minister Lalonde on April 19, 1983.[6] Here, the "cyclically adjusted" budget balances show a decline in the deficit as a percentage of G.N.P.[7] In conducting a similar experiment to adjust for inflation, the results dramatically illustrate the effectiveness of inflation in reducing the "real value of net fixed-value liablities" or the national debt.[8] This is a euphemism for ripping off the bondholders by repaying loans with debased currency. There would appear, then, to be a fundamental disagreement about the

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[4]See for example, Michael A. Walker, economic guru of Bennett the younger's administration, *Focus: On Balancing the Budget*, (Vancouver: September 1982); James M. Buchanan, *Public Principles of Public Debt: A Defense and a Restatement*, (Homewood, Ill: 1958); and James M. Buchanan and Richard Wagner, *Public Debt in Democratic Society*, (Washington: 1967).

[5]John Bossons and D.P. Dungan, "The Government Deficit: Too High or Too Low?" *Canadian Tax Journal*, Volume 31, No. 1 (January-February 1983), pp. 1-29. For other articles making essentially the same point see Richard Lipsey and Doug Purvis, "Deficit isn't the problem," *The Financial Post*, 31 July 1982, p. 7 and the following highly technical papers delivered at the Ontario Economic Council's Conference, "How Big and How Bad are the Deficits?" (Toronto: March 8-9, 1983): David Conklin and Adil Sayeed, "Overview of the Deficit Debate;" R.G. Wirick, "Fiscal Policy 'Crowding Out' in an Open Economy: The Canadian Case;" John McCallum, "Government Deficits: Historical Analysis and Present Policy Alternatives;" and Peter Dungan and Thomas Wilson, "Deficits and the Economy to 1990: Projections and Policy Alternatives."

[6](Ottawa: April 1983).

[7] *Ibid*, Table E-2, p. 61.

[8]*ibid*, Table F-1, p. 64.

wisdom of adding to our national debt. Each approach to state indebtedness is premised on certain assumptions which will be explored in Chapter II.

In exploring the nature of the public or national debt, it will be necessary to study the *politics* of state borrowing. Unlike a simple loan transaction between lender and borrower under the common law, public borrowing has, in the modern era, been approved by a duly constituted legislature, often, though not always, upon the recommendation of the executive.[9] In the United States congressional setting, a borrowing *ceiling* is authorized as a means of control. The ceiling must be raised should anticipated borrowings plus outstanding borrowings exceed the total allowed. This procedure has its advantages insofar as it makes the authorization of refunding much simpler. In other jurisdictions, American states and counties for instance, borrowing may only ensue when taxpayers in that jurisdiction approve the measure, there being a clear indication that borrowing, while temporarily postponing tax increases, will have longer-term taxation implications. The foregoing therefore suggests that a successful analysis of public debt requires at least some understanding of the legislative process, political party alignments, and the political and economic circumstances by which these loans are negotiated, approved and repaid.

More particularly, an examination of the state in its capacity as a debtor in a capitalist economic setting promises a better understanding of the nature of capitalist financial relations and secondarily, the function public debts serve in either stabilizing or destabilizing the economic system. While many studies on "tax incidence" and government expenditure patterns point out the relative distribution of economic power in society,[10]

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[9]Sir Thomas Erskine May, *A Treatise Upon the Law, Privileges, Proceedings and Usage of Parliament*, (London: 1844), pp. 325-331 on the requirements for the Crown to bring forward measures on borrowing which are then debated and passed in the Committee of Ways and Means. Sir Ivor Jennings notes that since the First World War, Parliament has given the Treasury wider discretion in its borrowings. Prior to the War, every *kind* of borrowing had to be specifically authorized by legislation and its purpose(s) identified. *Parliament*, Second Edition, (Cambridge: 1958), p. 337.

[10]For instance, W. Irwin Gillespie, *In Search of Robin Hood: The Effect of Budgetary Policies During the 1970s on the Distribution of Income in Canada*, (Montreal: 1976); "On the Distribution of Income in Canada," *Canadian Tax Journal*, Volume 24, No. 4 (July-August 1976), pp. 419-450 ; and the ill-fated budget document prepared by The Department of Finance, *Analysis of Federal Tax Expenditures for Individuals*, (Ottawa: November 1981). On the problem of unequal access to politicians and bureaucrats see Rianne Mahon's essay, "Canadian public policy: the unequal structure of representation," in Leo Panitch (ed.), *The Canadian State: Political Economy and Political Power*, (Toronto: 1977), pp. 165-198. On the expenditure budget process a number of interesting hypotheses have been developed by the "public choice" school. See William Niskanen, a MacNamara whiz kid, *Bureaucracy and Representative Government*, (Chicago: 1971);

It is probable that the study of the state–debtor and private–creditor relation may yield a better appreciation of the relative sway of the financial community over governmental economic policy–making. Here, the basic question to be asked is: *Does state indebtedness to financial institutions affect the sovereignty of a state?* Or, put differently, *how may indebtedness facilitate the influence of the financial interests over economic decisions taken by the state, in particular nationalization and taxation policies?* If one assumes that it does– what is the character of this influence or dependency? Further, *does the nationality of the debtholder alter in any way, the debtor-creditor relationship?* And lastly, *is the so-called "relative autonomy of the state" limited, in part, by the constellation of financial institutions which lend money to the state?* The approach adopted in exploring these broad questions will consist of an historical review that outlines the development of public debt, debt management, and the institutions engaged in debt management at the federal level.

Scope and Plan of Study

According to J.M. Keynes, the "permanent relations between debtors and creditors....... form the ultimate foundation of capitalism."[11] In making these relations more intelligible, it is necessary to identify the central factors which influence the prices for trading bonded debt and *deviations* from this relatively stable set of "permanent relations between debtors and creditors." To gain a better appreciation of these stable economic patterns, we shall explore the management of federal government borrowing during the 1930–1952 period. Also, we shall explore the circumstances surrounding the Province of Alberta's principal default on April 1, 1936; the first such default on principal by any Canadian province at that time and since.

The study will cover the period 1930 to 1952 and focus on the theory, structure, and politics of public debt and debt management at the federal level. This time frame has been selected in order to incorporate three distinct time periods: depression (1930–39), war (1940–45), and post–war reconstruction and prosperity (1946–52). Each

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[10](cont'd)Mancur Olsen, *The Logic of Collective Action*, (Cambridge, Mass: 1965); Albert Breton, *The Economic Theory of Representative Government*, (Chicago: 1974). See also Aaron Wildavsky's *The Politics of the Budgetary Process*, Third Edition, (Boston: 1976) and from a Marxist perspective James O'Connor's *The Fiscal Crisis of the State*, (New York: 1973).

[11]*The Economic Consequences of the Peace*, (New York: 1920), p. 37.

sub-period is unique in terms of its politics, economics and the objectives and constraints facing the Dominion's debt managers in addition to the vast differences in the borrowing requirements. Given this wide variation in environmental factors, an attempt is made to assess how debt management theory and practice are affected by the changing economic and political circumstances.

The second principal reason for choosing the 1930-1952 period is simply the product of a governmental rule which, regrettably, limits access to "classified documents" that are younger than thirty years old. In weighing the advantages, disadvantages, costs and benefits (and skills of the researcher) associated with a more quantitative, long-term study against an historical, more intensive examination of the available archival documentation, the latter approach was chosen. This decision can be defended on the basis that reliable statistical evidence is available back to the 1930s and furthermore that access to materials on deposit at *The Bank of Nova Scotia Archives* and *Bank of Canada Archives* relating to federal and Alberta government borrowing are also subject to limitations after 1953.[12] Archival materials do provide the student of public policy with a better insight into decision-making than that provided by contemporary newspaper analysis and quantitative analysis, the latter frequently lacking in a longer-term perspective. Needless to say, materials relating to decisions taken by the central bank and the chartered banks as recently as 10 years ago are well protected from the gaze of the outside commentator.

The purpose in restricting the investigation to the federal level primarily is to keep the available data and materials within manageable limits. The study of debt management has not been the subject for review by political scientists in Canada and the studies undertaken by economists in Canada and the United States are quite technical and usually modelled on theories of portfolio analysis.[13] Unlike the economist who is principally, though not exclusively, preoccupied with the optimal allocation of capital, the political scientist is interested in the motivations for borrowing and the consequences for the

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[12]Of course, one of the obvious difficulties in such a survey is that many of the principal participants have since passed away.

[13]For example Ivan Charles Johnson, *Provincial and Municipal Debt in Canada 1946-1966*, Unpublished Ph.D. dissertation, University of Western Ontario, Department of Economics, 1971 and Karl Anton Wust, *Debt Management: Canadian Provinces 1954-1965*, Unpublished M.A. Thesis, Carleton University, Department of Economics, 1967.

political system from increased or decreased borrowing. It is also of interest to evaluate how the political system, subsuming both the administrative and judicial systems, performs when it comes to making choices about the rights of debtors and creditors or bondholders. While the economist asks whether funds directed into the government sector are an optimal allocation of economic wealth, the political scientist addresses the question, *to what extent is the state compromised in its dealings with its creditors on matters outside the debt management function?*

Assumptions

As will become evident to the reader, the author's bias is towards a prudent and limited use of the borrowing authority in order to ensure full accountability of the political authority to the sovereign people. Debts imply burdens and I believe there is a potential for grave distortion of the democratic process when money is borrowed either from central banks or from private sources to finance operating programmes as opposed to capital programmes. Furthermore, the accumulation of debts which now appears to be endemic in western countries at the present time, seriously impairs the fiscal manoeuvrability of governments which now spend between 15 and 25 per cent of their budgets on simply paying interest on the debt. Debts also imply obligations: an obligation on the part of the Government as political agent of the "people" to meet debts contracted by the Goverment on "behalf" of the people. Such obligations, in my view, give the creditor classes and their representatives, the opportunity to exert influence, undue or otherwise, on the policies of democratically elected governments. This influence may or may not be a bad thing. Nevertheless, the contraction of debts may very well have the tendency to distort the political process.

Limitations

At this juncture, it should be made clear that the conclusions of this study are not intended to be interpreted as a "general theory" of public debt and debt management in a liberal democratic society. Rather, it is a case study and a record of the performance of one government's management of its borrowing activities during a period of immense political, economic, and institutional change. As such, generalization is limited by the relatively short time frame (22 years), the size of the sample (one government) and the number of participant institutions included in the study (Dominion, banks, dealers,

"international capital"). The development of a more general theory would therefore require a comparative analysis of perhaps one half dozen governments over a relatively lengthy time period, say 50 years, and the examination of other key institutional actors such as life insurance companies.

Motivations

What emerges from the study is a history of institution–building in Canada during the 1930s and 1940s. The events which led to the creation of a central bank, a housing and export insurance corporation are rooted in the complex interplay of new ideas, both political and economic, and the financial motivations of the key institutional actors in the study. More specifically, the study reveals that the behaviour of government debtors and institutional creditors can best be understood as institutions seeking to minimize interest costs in the case of the former and to maximize real rates of return in the case of the latter group. This quest for maximizing and/or minimizing the rate of interest are the primary motivations underlying the tension between debtors and creditors. This characterization is broadly consistent with economic models describing the behaviour of profit–maximizing institutions.

What also emerges from this examination are a series of sub–hypotheses relating to the behaviour of interest groups, a subject addressed in Chapters VI and VII. These hypotheses pertain to the relationship between the Dominion *qua* regulator and the regulated industry in a federal state and matters relating to the institutionalization and formal recognition of interest groups by the federal state. It is hoped by considering the activities of these key interest groups along with the actions of individual corporate members, that a fuller elaboration of this complex process is rendered.

This study is divided into four basic parts. The first segment investigates theories of public debt while the second main segment consists of an overview of the economic and political environment in which decisions on managing the national debt during the 1930 to 1952 period, were taken. Part three, which constitutes the empirical core of the study, examines the objectives and requirements of the main participants in the debt management process: federal officials, chartered banks, investment dealers, and international capital. This style of organization mirrors, to some extent, the structure of other studies on

Canada's financial markets.[14] The final segment explores the circumstances surrounding the default by the Province of Alberta in 1936 with a view to highlighting the nature of the debtor–creditor relationship as well as the difficulties associated with the theory and practice of debt management.

In order to grasp the influence theory may have on the practice of policy–making, an extensive review of the literature on public debt is undertaken. For purposes of analytical clarity two distinct schools of thoughts– the "burden of the debt" school and the "benign school of public debt" are posited. The "burden school" calls for a reduction of the national debt and concomitant with this view, a smaller state sector. The benign school is generally "risk averse" to growing state debts and pushes for indebtedness as part of a "counter–cyclical" fiscal policy in stabilizing or normalizing social and economic relations. The second part of Chapter II will monitor the discussion in the Canadian setting regarding the debt and government finance by Canadian acadmics, bankers, and officials.

After setting out the "theoretical baggage" carried into the debt management process by the key participants, Chapter III will provide a brief commentary on the performance and character of the Canadian economy. The examination will look at the three sub–periods defined earlier, the depression, the war, and the post–war period. The statistical information will include data on national income, employment, price levels, government finance including borrowings, international trade, and bond yields. This background will be helpful in setting the stage for a survey of *political debates* on the public debt and over public finance in general. This account will explore the respective position of the main political parties on the public debt. A brief analysis will also be undertaken of the views of Canada's appointed chamber of so–called "sober second thought" in order to access whether this august body was indeed more protective of creditor's interests as is commonly supposed. Particular attention will be drawn to the monetary agitators who, according to Irving Brecher, performed an influential role in forging a new perspective towards the state's role in monetary and credit management.[15] These agitators were drawn mainly from Western Canada and were associated with the

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[14]For instance, E.P. Neufeld, *The Financial System of Canada*, (Toronto: 1972) and Bruce King Maclaury, *The Canadian Money Market: Its Development and Its Impact*. Unpublished Ph.D. dissertation, Harvard University, Department of Economics, 1961.
[15]*Monetary and Fiscal Thought in Canada, 1919-1939*, (Toronto: 1957).

United Farmers of Alberta, the Progressive, Labour, and C.C.F. parties although some Liberals, notably the renegade Gerry McGeer and Ian Mackenzie were known as sharing many criticisms of the financial system with "third party" members.

The first three substantive chapters thus are designed to set the context in which the task of debt management was undertaken. Chapter V examines debt management from the standpoint of the *administrator* acting on behalf of the government issuer, that is, officials in the Department of Finance and the Bank of Canada (after March 1935). The analysis is organized chronologically and will focus on the achievement of stated goals and the constraints which the debt manager was forced to overcome; in particular, the volume and form of indebtedness, market conditions, and political commitments.

The three succeeding chapters investigate debt management from the viewpoint of the *creditor*. During the period under scrutiny, chartered banks became, by far, the largest institutional holders of government stock. In assessing their role in the process and their influence on debt management decisions and upon economic policy-making in general a "financial statement" approach is adopted. This approach posits that in dealings with governments, a financial institution's actions will be structured by its own assets and liabilities which, in turn, generate a return to the shareholders. As "salaried trustees" chartered banks will act to (1) protect the *security* of their investment and (2) maximize the "spread" between earning assets and deposit liabilities. In short, financial rewards structure the behaviour of bankers as individual representatives or expressions of an overriding imperative to maximize the spread between earnings and interest expenses.

While financial information about investment dealers was sketchy and remains somewhat clouded even today, it is possible to establish the main financial rewards and incentives motivating these smaller, marketing organizations. "Dealers" are primarily engaged as underwriters and as brokers (See Appendices A and B.). In these capacities they have a vested interest in actively encouraging borrowers to come to market with an "offering" and in an active *secondary market* in which trading takes place. The dealer earns an underwriting fee or commission for *primary distribution* of the securities and receives commissions in the secondary trading of securities previously distributed. Commissions and inventory profits therefore constitute the daily bread of the dealer unlike the fixed income returns to life insurance companies and banks who purchase for

investment reasons and sell for reasons of liquidity. As with chartered banks, the relative influence dealers had on debt management in particular and economic management in general will be explored.

Throughout the 1930s, a large number of municipal governments were forced to default on their maturing obligations. In these circumstances, the value of the bonds fell precipitously as did the value of other municipal securities in the same region or province.[16] At this time, the Dominion desperately sought to maintain its own credit-worthiness by advancing tens of millions of dollars to the provinces to stave off a provincial default. As will be demonstrated, foreign investors were not interested in the subtleties of the *British North America Act* which permitted provinces to borrow on the "sole Credit of the Province." In Chapter VIII this perception of international capital is examined in more detail as well as other factors impinging on the successful marketing of Dominion stock in London and New York.

Chapter IX documents the reaction of the chartered banks and the Dominion to the crisis precipitated by Alberta's decision in March 1936 to reject the Loan Council plan and to default. This chapter is aimed at further clarifying the complex web of relations between foreign and domestic capital, central banks, and the federal and provincial governments. From the evidence presented, it is evident that an all-out effort was made by the Dominion, the Bank of Canada, and the chartered banks to isolate this aberrant government and to prevent the spread of repudiation east and west. It should be remembered that the assumption of political power by parties dedicated to a redefinition of debtors' rights in the face of an intransigent, unified creditor class was by no means unique to Alberta.[17] This chapter is intended to complement rather than duplicate the prodigous scholarship on rise of Social Credit in Alberta.[18]

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[16]See Thomas Bradshaw, "Maintenance of public credit and its relation to the present financial position of many Ontario municipalities," *Canadian Chartered Accountant*, (February 1935), pp. 119-133.

[17] The Greenbacker and "free silver" movements in the United States are just two instances of agrarian-led protest movements opposed to the "interests" in the east.

[18]V.F. Coe, "Dated Stamp Scrip in Alberta," *Canadian Journal of Economics and Political Science*, Volume 4, No. 1 (February 1938), pp. 60-91; A.F. McGoun, "Social Credit Legislation: A Survey," *Canadian Journal of Economics and Political Science*, Volume 2, No. 2 (May 1936), pp. 512-524; J.A. Irving, "The Evolution of the Social Credit Movement," *Canadian Journal of Economics and Political Science*, Volume 14, No. 3 (August 1948), pp. 321-341 and *The Social Credit Movement in Alberta*, (Toronto: 1974); J.R. Mallory, "Disallowance and the National Interest: The Alberta Social Credit Legislation of 1937," *Canadian Journal of Economics and Political Science*, Volume 14, No. 3 (August 1948), pp. 342-357, "The Lieutenant-Governor as a Dominion Officer. The

In thius survey, the structure of Alberta's economy, the structure of its public debt and the response of the main creditors to this attack on its rights are sketched.

The following two sections set out the necessary definitions and techical background for a study of this kind and then address, in some detail, the significance for the study of public debt and debt management in the field of political science.

Definitions

We shall define *public debt* as the *total unmatured* debt obligations of the government *including* those obligations held by the Government and the central bank, payable in Canadian *and* foreign funds. This definition does *not* include the explicit or implicit guarantees as to principal and interest given for agents of the Crown. We do this to simplify the analysis somewhat because the data on these "contingent liabilities" is difficult to aggregate, especially when there is some dispute as to what is an agent of the crown. [19]

Government debt may be absorbed by the central bank which pays for the securities either by selling its bill or bond holdings or through the issuance of "legal tender" or "fiduciary notes". "Monetizing" the debt refers to the practice of the Bank financing its purchases through an increase in its note circulation– that is, the Bank's own liabilities. The

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[18](cont'd)Reservation of Three Alberta Bills in 1937," *Canadian Journal of Economics and Political Science*, Volume 14, No. 4 (November 1948), pp. 502–507 and *Social Credit and the Federal Power in Canada*, (Toronto: 1976); C.B. Macpherson, "The Political Theory of Social Credit," *Canadian Journal of Economics and Political Science*, Volume 15, No. 3 (August 1949), pp. 378–393 and *Democracy in Alberta: Social Credit and the Party System*, (Toronto: 1974); E.J. Hanson, "Public Finance in Alberta since 1935," *Canadian Journal of Economics and Political Science*, Volume 18, No. 3 (August 1952), pp. 322–335 and Hugh Whalen, "Social Credit Measures in Alberta," *Canadian Journal of Economics and Political Science*, Volume 18, No. 4 (November 1952), pp. 500–517. It is perhaps no coincidence that moneys for some of this research had been provided from none other than the Rockefeller Foundation flowing through the Canadian version of the Social Science Research Council.

[19]In the *Public Accounts of Canada* for the fiscal year ended March 31, 1975 these contingent liabilities relating to loan guarantees totalled some $15.6 billion. The recognition of this potential exposure was reported by way of a note by the Auditor General, *not* by the Government. In the 1978 *Public Accounts*, contingent liabilities were stated in a footnote at $23.7 billion. In the 1982 Public Accounts a completely new definition of contingent liabilities reduced the figure to $5.6 billion. The figure included a new category "Pending or threatened litigation" – $2.1 billion and excluded N.H.A. insured mortgages of some $17 billion footnoted in 1978. In his 1982 *Annual Report* to the Commons the Auditor General expressed concern about the use of "letters of comfort"– "a device under which a minister is authorized by the Cabinet to support the credit of a corporation. Even when they contain a disclaimer, the moral obligation of the Government is clear." p. 12. Canadair was singled out with a potential exposure of $1.35 billion– a rather insignificant sum by current Ottawa standards.

debt may also be sold to the banking system which may liquidate other assets to buy the government's debt or by increasing the Government's account balance with the chartered banks. Sales to the general public include Canada Savings Bonds, a *non-marketable* asset sold only to individuals and estates. *Marketable* bonds are usually sold to industrial corporations, investment dealers, wealthy individuals, and to insurance and trust companies. Examples include the Victory Loans sold during the last war. Non–residents too are entitled to hold these debt instruments payable in Canadian funds. As at December 1982, it was estimated that approximately 11 per cent of Canada's direct and guaranteed debt was held by non–residents. (See Appendix A)[20]

Reasons for indebtedness

Borrowing may be necessitated by (1) a deficiency in revenues, (2) an excess in expenditures, (3) an expected or unexpected war or (4) to refund maturing debts. A fifth category may be added– theoretically justifiable deficit financing. This rationale was, for all practical purposes, not applied in the period under consideration. To discriminate between a "deficiency in revenues" or "excessive expenditure" is a difficult, if not futile, exercise. Whatever the cause, the resulting deficit must be financed by the sale of government debt or increased taxation.

Debt Management Defined

Debt management is a complex and vital governmental function possessing its own vocabulary, culture, and community. Sound debt management depends upon an intelligent reading of capital and money market movements, an extensive network of contacts on the "street" (a street which is now international in scope) and that elusive and priceless asset, "good judgment". Debt management may be defined as (1) maintaining data on outstanding direct and guaranteed debt, and (2) *advising* the borrower on the terms, conditions, timing, and size of a new offering. In Canada, the debt manager, the Bank of Canada *advises* the Minister of Finance who then recommends to the Governor in Council the terms and conditions of a new issue. It is the Minister of Finance who is ultimately responsible and accountable for the conduct of debt management.[21]

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[20] *Bank of Canada Review*, June 1983, Table 22.
[21] See Bank of Canada, *Submission by the Bank of Canada to the Royal Commission on Banking and Finance*, Ottawa, May 31, 1962, Submission IV, p. 46. See also statement of J.E. Coyne cited in Douglas Fullerton, *The Bond Market in Canada*, (Toronto: 1962), pp. 60–61.

This distinction between the locus of advice and the locus of decision-making is vitally important from the viewpoint of the central bank. Governor Graham Towers, in response to C.D. Howe's statement in the Commons' Standing Committee on the Bank's involvement in the 1938 refunding operations, wrote:

> I mentioned also that the relation of Central Bank to Government was a very special one, and that the name of the former should not be mentioned by Government as a source of advice. If it was only mentioned as the source when the Government is being criticized, the Bank would get into bad repute. But it would not be sensible for the Government to mention that they had received our advice on every occasion when they took action of a financial character. In any event, we were not the makers of policy in relation to Government finances.[22]

Objectives

The objectives of debt management may be summarized as follows:

1. To ensure that an issue brought to market is absorbed with a minimum of disturbance to the prices of outstanding issues traded in the secondary market.

2. To minimize interest and borrowing costs to the issuer (the government) by ensuring the bonds are priced competitively. This may involve selling bonds with a shorter term to maturity as shorter-term securities *traditionally* earn lower rates of return.

3. To broaden the market in government securities by selling to as wide a group of investors as possible.[23] A wide "placement" implies less fluctuations in price should any group of institutional investors be forced to liquidate their holdings.

4. To maintain a balanced spread of maturities in order to avoid an extremely heavy refinancing operation at one point in time.[24] This goal necessitates periodic funding operations.

5. To provide flexibility in operations by not adhering in a doctrinaire way to a set formula on debt management.[25] Flexibility can be achieved by a variety of means including improved spacing of maturities, the use of auctions for longer term bonds,[26] call features and the issue of extendible or retractible bonds.

The inherent conflicts of these objectives should also be identified. "Democratization" of the debt or a wide "placement" is expensive for distributing a large volume of small denomination bonds requires considerable organization, time and effort of sales personnel. Selling short-term securities implies lower interest charges *if* the

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[22] Towers Memoranda, No. 129, 3 May 1938, "Conversation with Mr. Howe on subject of his remarks during hearings of Committee on Railways and Shipping," *Bank of Canada Archives*.
[23] Royal Commission on Banking and Finance, *Report*, (Ottawa: 1964), p. 325.
[24] See for example William C. Hood, *Financing of Economic Activity in Canada*, A Study Prepared for the Royal Commission on Canada's Economic Prospects, (Ottawa: July 1958), pp. 454-455.
[25] Royal Commission on Banking and Finance, *Report*, p. 456 and Fullerton, pp. 220-221.
[26] Robert V. Roosa, "Integrating Debt Management and Open Market Operations," *American Economic Review*, Volume 42, No. 2, (May 1952), pp. 230-232.

historical relationship between long and short–term rates holds. Yet short–term refinancing entails recurring commissions and may cause a secular interest rate rise on short–term, money market instruments when the short–term market becomes saturated.

Funding the debt refers to the frequent practice of issuing new bonds with a term to maturity of one year or more. Normally a funding operation is essentially "refunding" a maturing issue. Funding, by definition, extends the average term to maturity of the debt. The *funded debt* is that portion of the public debt with a term to maturity of one year or more. The *floating debt* is that portion of the debt which comes due in less than one year.

A *fiscal agent* handles the mechanical aspects of loan flotations. These functions involve the maintenance of registration books, payment of interest and principal on behalf of the Government, the printing and delivery of bonds, redemption and cancellation of bonds. While the Bank of Canada may be said to act as the Government's "paying agent", it does not "negotiate" with investors *per se,* although section 7(c) of the *Consolidated Revenue and Audit Act,* refers to this aspect of fiscal agency specifically. According to Governor Towers:

> The services performed by the Bank of Canada at the time of issue of loans cannot, in any way, be construed as "negotiating loans." Negotiations can only take place with buyers or underwriters who agree in advance to purchase or underwrite a loan at a specified price. When a loan is brought out by the Bank of Canada on behalf of the Minister of Finance, we do not "negotiate" with the public. [27]

Although this thesis does not explore the politics of budgetary policy, several related fields of government economic policy–making should be defined in order to distinguish debt management from other financial functions of governments. *Fiscal policy* is taken to embrace those financial operations involving budgetary revenues and expenditures and, more particularly, the enactment of taxation measures and the authorization of expenditure by Parliament. Note this definition is broader than the precise definition usually accorded by economists: "The adjustment of tax rates or government spending in order to affect aggregate demand. (Pure fiscal policy involves a change in government spending or tax rates unaccompanied by any change in the rate of growth in the money stock.)"[28] In a broader context, fiscal policy involves decisions about budgetary

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[27]G.F. Towers to W.C. Clark, 17 June 1941, *Public Archives of Canada,* RG 19, Volume 605, File 155–75.

[28]Ake Blomqvist, Paul Wonnacott and Ronald Wonnacott, *Economics: First Canadian Edition,* (Toronto: 1983). p. 829.

surpluses or deficits which will affect both monetary and debt management policy. The important thing which should be borne in mind is that *monetary policy* entails the selling of the debt to the banking system, notably the central bank – "monetizing" the debt. This monetization process may be an attractive option to the finance ministry because the central bank is owned by the government and monetization may circumvent the need to raise taxes in the short run. With the release of the *White Paper on Employment and Income* in April 1945, fiscal policy was directed towards "economic stabilization". This meant that the Government would balance the budget in the "long run" while running short-term deficits or surpluses to remedy periodic economic recessions or booms. Fiscal policy, so conceived, seeks to increase the national income and employment, improve the distribution of income and to sustain a balance in trade with the rest of the world.

Monetary policy is defined to comprise the levers by which the central bank influences the growth of the money supply and influences credit conditions. These levers include open-market operations, the manipulation of chartered bank reserve requirements, temporary ad hoc arrangements with chartered banks on loan policies, and moral suasion. The major objective of monetary policy is a stable price level for domestic goods and services. Monetary policy does *not* include the purchase, on behalf of the Government, of outstanding marketable bonds for the purpose of stabilizing the market for "Canadas" as was done in September and December 1947.

The harmonization of fiscal, debt management and monetary policy objectives are seldom easy in spite of the institutional division of labour which helps to conceal these policy conflicts.[29] According to Neufeld:

> This harmony of functions is somewhat misleading because though the Bank performs the functions of monetary and debt manager, only the former function was independently controlled by the Bank. To be sure, the debt manager made recommendations to the Minister which were rarely, if ever, challenged. Nevertheless, the legal distinction is important, for, as we shall see, the willingness of the Government to borrow instead of to tax, makes it extremely difficult, if not impossible, to conduct a policy of lowering interest rates, without a commitment by the government to lower its cash requirements through borrowing. While, strictly speaking, a debt manager is simply a *technical advisor*, the institutionalization of these various functions under one roof does not prevent conflicts from arising.[30]

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[29]E.P. Neufeld, *Bank of Canada Operations and Policy*, (Netherlands: 1958), p. 15.
[30]Neufeld, 1958, p. 17.

Political Significance

Historical Perspectives

Any historical review of state indebtedness is replete with colourful accounts of court intrigues involving conspiratorial money lenders. Professor Tawney's account noted below is especially dramatic:

> But behind Prince and Pope alike, financing impartially Henry VIII, Edward VI, and Elizabeth, Francis, Charles, and Philip, stood in the last resort a little German banker, with branches in every capital in Europe, who played in the world of finance the part of the *condottierri* in war, and represented in the economic sphere the morality typified in that of politics by Machiavelli's Prince. Compared with these financial dynasties, Habsburgs, Valois, and Tudors were puppets dancing on wires held by a money power to which political struggles were irrelevant except as an opportunity for gain.[31]

A more balanced account is given in the following passage by Gabriel Ardant.

> Governments have found financiers useful since the Middle Ages to ease the movement of funds, anticipate the payment of tax receipts, and even to take charge of running taxation. These bankers helped states profit by banking techniques which transferred payments from one end of Europe to the other. The Empire of Charles V or of Philip II would have been impossible to run without the assistance given by the bankers of Genoa and southern Germany.[32]

In spite of the aid provided the state by bankers, the symbiosis of banking, finance and politics still remained problematical. Charles Beard's classic study, *An Economic Interpretation of the Constitution of the United States* explains that the outcome of the Philadelphia Convention was effectively determined by a coterie of politician–landowners–lawyers who had considerable holdings of continental stock. Beard claims that it was no coincidence that the constitutional accord, to borrow a Canadian phrase, gave to the central government superordinate powers in the realm of taxation.[33]

Currency Backed by Public Debts

Suppose you find yourself in the shoes of a Minister of Finance. You learn that the State Treasury is practically empty and merchants, soldiers, and government contractors are clamouring for payment of debts owing. You are advised that the Assembly cannot be

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[31] *Religion and the Rise of Capitalism*, (Harmondsworth: 1972), p. 88. See also Eric J. Pulton's "Famous Banking Houses No. 1– The Rothschilds," *The Journal of the Canadian Bankers' Association*, Volume 41, No. 4, (July 1934), pp. 479–488.
[32] "Financial Policy and Economic Infrastructure of Modern States and Nations," in Charles Tilly (ed.), *The Formation of National States in Western Europe*, (Princeton, N.J: 1975), p. 189. See also Walter Stewart's amusing account of the evolution of banking in the Asia Minor and Europe in *Towers of Gold. Feet of Clay*, (Toronto: 1982), Chapter 2.
[33] (New York: 1965)

recalled to impose new and higher taxes because taxes are already too onerous and this would give the opposition radicals a platform for criticizing the Government's military and domestic policies. All debts owing are paid in coin specie (gold and/or silver). It is decided therefore to issue new coins with a reduced weight but with the same nominal value to *domestic* creditors. Furthermore the outstanding specie will be recalled, melted down and reissued. This process effectively increases the state's capacity to pay its debts in inverse proportion to the amounts shaved from the existing stock of circulating coin. This practice was popular and remains prevalent amongst governments during periods of war and social unrest when further taxation would likely precipitate outright revolt on the part of the general population. Another means of debasing coins was to mix in cheaper metals, often copper with gold and silver.[34] The same process is resorted to frequently nowadays by most governments.

This deception was soon recognized by astute merchants, contractors, and the public who simply readjusted their prices upward to recoup losses suffered through debasement. A more complicated system of currency management– a system based on government certificates of indebtedness, I.O.U.s basically, and specie was advanced.[35] The creation, through statute or charter, of a national bank of discount, granted a monopoly over the note issue and the privilege of government borrowing from that bank. In return for borrowed specie or bank–notes, the Government delivers a bond or bill pledging repayment in specie or bank–notes. From the bank's point of view the loan was essentially secured by the imposts and other levies accruing to the State Treasury. There was, in short, virtually no risk involved in issuing bank–notes or specie to the State. The bank would then *discount* the government's bills or bonds (government stock) by advancing a sum smaller than the face value on the stock held. Knowing the daily demand for redemption of its bank–notes in specie was less than the specie held in reserve, the bank could issue bank–notes up to various multiples of the reserve specie holdings. So long as

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[34]See G.D.H. Cole, "Money," in G.D.H. Cole, *What Everybody Wants to Know About Money*, (London: 1936), pp. 25–26.

[35]*Money* will be taken to mean a universal exchange medium including coins, private and state bank–notes and legal tender notes but excluding chequable deposits. *Currency*, according to R.G. Hawtrey "means any hand–to–hand medium of payment, and includes both coin and notes, whether legal tender or not, but excludes bank credit in the form of deposits which cannot themselves be handled, and are assigned by means of credit instruments such as cheques." Or, in other words, money defined above plus chequable deposits. *Currency and Credit*, Fourth Edition, (London: 1950), p. 5.

there was no panic demand for redemption in specie, this system of partially specie backed currency operated effectively. The face value of the paper money above and beyond the gold and silver holdings is known as the *fiduciary note* issue.[36] Thus the fractional reserve system of banking was born.

The Canadian Development

In Canada the lack of specie in the early years of settlement led to French Canada's experiment with "playing card" money. [37] At the time of the Conquest colonial *livres* were declared by the victors to be worthless yet were snapped up by enterprising British merchants. This speculation was rewarded with the signing of the Treaty of Paris which redeemed in specie these *livres* at 25 to 50 per cent of their original value.[38]

The second phase in the development of a debt-supported currency is a reserve system based on specie, discounted government debt and high grade, discounted commercial bills. A third phase, a pure fiduciary note issue are notes backed entirely by the state's debt. In this case the government owns or controls a central bank whose only assets are government bonds and whose main liability are its notes in circulation. This is the "legal tender" stage, legal tender meaning that the settlement of all *domestic* debts, private and public, are accomplished by the transfer of legal tender or *fiat money* between the borrower and the lender. Put simply, all economic actors are forced to accept this legal tender, paper money in the settlement of debts. As one can see, this very simple method offers an attractive option for a desperate government seeking to meet its outstanding debts. Currently all legal tender money in Canada represents the central bank's holdings of the national debt or state IOUs.

The Dominion of Canada was quite slow to tap this method of finance, the pure form of a fuduciary note issue, preferring to allow the banks to issue their own bank-notes providing the main medium of circulation in the country. Before 1914, Dominion Notes were basically "gold certificates", that is to say, notes which could be presented at the Finance Department and redeemed in gold. Dominion Notes therefore

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[36] The earliest recorded example of this fiduciary currency was the "deposit receipt" sanctioned by the Chinese Chou Dynasty in the ninth century A.D. Here and elsewhere this development grew out of a scarcity of metallic currency. Ernest Mandel, *Marxist Economic Theory*, (London: 1971), pp. 248-249.

[37] Richard A. Lester, "Playing Card Currency of French Canada," in E.P. Neufeld, (ed.), 1964, pp. 9-23.

[38] R. Craig McIvor, *Canadian Monetary, Banking and Fiscal Development*, (Toronto: 1958), pp. 8-10.

formed a major part of the cash reserves of the banking system. With the outbreak of World War I, the *Finance Act* permitted an increase in the Dominion notes in circulation which was not backed by gold.[39] The Act allowed banks to deposit with the Department securities to be discounted in exchange for Dominion notes. In 1923 the Act was extended but on 1 July 1926 Canada returned officially to the gold standard meaning that bank-notes and Dominion notes were again redeemable in gold.

As many writers have observed, the operations of the *Finance Act* from July 1926 up to 1929 placed the Department in "the position of paying out Dominion notes with one hand and cashing them for gold with the other."[40] In order to stem an outflow of gold to New York commencing in 1927-28, the redemption of gold was practically suspended which might have been illegal.[41] Irregularities were observed as early as March 1927 when foreign exchange quotations indicated that the free flow of gold (based on the predictable "gold points" -the costs of shipping gold between Montreal and New York) was not being maintained. While *de facto* abandonment of gold occurred in late 1928 this fiction was maintained until the *de jure* abandonment was formalized on October 19, 1931. Throughout the piece there was absolutely no attempt made by the Finance Department to stem the tide of redemptions by raising the rediscount rate for the securities deposited for Dominion notes.[42]

The first attempt by the Government to issue fiat money came in November 1932 when four per cent treasury bills were sold to the banks and rediscounted at three per cent in exchange for an advance of $35,000,000 in Dominion notes.[43] This effort was greeted with some skepticism in socialist quarters[44] and doubt in the halls of financial institutions. In any event, it was the first time that the government actively used the *Finance Act* to increase Dominion notes in circulation. What some analysts perceived to be a more profound change were amendments made to the *Dominion Notes Act* in 1933

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[39]Professor F.A. Knox discussed this revolutionary development in his "Proposal for a Central Bank," *Queen's Quarterly*, Volume 40, No. 3 (August 1933), p. 430.
[40] C.A. Curtis, "The Canadian Monetary Situation," *Journal of Political Economy*, Volume 40, No. 3 (June 1932), p. 324 and A.K. Eaton, "A Central Bank for Canada," *Dalhousie Review*, Volume 13, No. 4 (1934), pp. 440.
[41]Eaton, p. 435 and Curtis, 1932, pp. 322-324.
[42]Curtis, 1932, pp. 326-327.
[43] See Courtland Elliott, "Bank Cash," *Canadian Journal of Economics and Political Science*, Volume 4, No. 3 (August 1938), p. 459.
[44]See Eugene Forsey, "Inflation in Canada," *The Canadian Forum*, Volume 13, No. 147 (December 1932), p. 88.

and 1934. In 1933, the Governor in Council was delegated authority to suspend the redemption of Dominion notes in gold which was immediately done. In 1934, amendments reduced the minimum gold cover of the Dominion notes issue to twenty-five per cent. This permitted the expansion of the note issue by some $50,000,000.[45] So by 1934 Canadian money was no longer redeemable in specie and only partially backed by gold. With the transfer of the Bank's gold reserves to the Foreign Exchange Board in the early part of the War, the final move towards a totally state debt backed monetary unit was accomplished.

The Dangers of Inflation

The capacity to issue legal tender is theoretically limitless. In practice, however, an *independent* central bank is unlikely to comply with the wishes of a government for an "easy money" policy. Independently minded central bankers always stand for "sound money" and against irresponsible, expansionary fiscal policy.[46] This power to create more money by the sale of government debt to the central bank affects all economic relations as paper money is the fluid which makes our present economic system function. When there exists a general suspicion that coinage and currency are being debased, that suspicion is correctly directed towards the state. As the discipline of gold has been superseded and replaced by the fiscal discipline of governments and monetary discipline of central banks, there is often an incentive for governments to repay their debts through currency manipulation. Commenting on the grave social, economic, and political consequences of inflation, J.M. Keynes noted in *The Economic Consequences of the Peace*

> Lenin is said to have declared that the best way to destroy the Capitalist System was to debauch the currency.[47] By a continuing process of inflation, governments can confiscate secretly and unobserved, an important part of the wealth of their citizens. By this method, they not only confiscate, but they

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[45] See S.R. Noble, "The Monetary Experience of Canada during the Depression," *The Journal of the Canadian Bankers' Association*, Volume 45, No. 3 (April 1938), pp. 274-275.

[46] See Michael J. Brenner, *The Politics of International Monetary Reform*, (Cambridge, Mass: 1976), pp. 11-13 and also Royal Commission on Banking and Finance: "The main reason, however, for conferring some measure of autonomy on the central bank has been the historical tendency of governments of all forms to develop the habit of inflating the currency. Since the process of inflation is understood by relatively few people and since it has few organized opponents in our society, a special responsibility is imposed on the central bank to see that the objective of price stability is not forgotten by government merely because other goals have more political popularity in the short-run." in James P. Cairns and H.H. Binhammer (eds.), *Canadian Banking and Monetary Policy*, (Toronto: 1965), p. 100.

[47] I am indebted to David Leadbeater of the University of Windsor for pointing out to me that this attribution to Lenin has never been substantiated.

> confiscate *arbitrarily*; and, while the process impoverishes many, it actually enriches some. The sight of this arbitrary rearrangement of riches strikes not only at security, but at confidence in the equity of the distribution of wealth. Those to whom the system brings windfalls, beyond their deserts and even beyond their expectations of desires, become "profiteers", who are the object of the hatred of the bourgeoisie, whom the inflationism has impoverished, not less than of the proletariat. As the inflation proceeds and the real value of the currency fluctuates wildly from month to month, all permanent relations between debtors and creditors, which form the ultimate foundation of capitalism, become so utterly disordered as to be almost utterly meaningless; and the process of wealth-getting degenerates into a gamble and a lottery.[48]

The capacity of a government to undermine the domestic value of its currency and coin stands in sharp contradistinction to its inability to repay *external* debts by inflationary methods. (The exception to this rule is the Government of the United States whose currency is still respected as an "international reserve" currency.) The external value of the Canadian dollar– Canadian dollars held by foreigners– is currently backed by approximately 20 million ounces of gold and between two and four billion U.S. dollars in the Exchange Fund account. Canada, unlike the United States, cannot simply print more dollars to pay for its trade deficits and/or foreign investments without risking a serious decline in the value of its currency. Here the law of supply and demand applies– the greater the supply of Canadian dollars, the lower their market value. Canada must finance its trade deficits by drawing down its exchange holdings or by resorting to heavy offshore borrowing, as was done in 1978-79. The value of Canada's dollar in foreign markets therefore is based on Canada's gold holdings, foreign exchange holdings and its trade balance. The U.S. Treasury, meanwhile, is still able to issue more fiduciary notes as other central banks reluctantly continue to accept these notes which are effectively claims on the U.S. Treasury and were, before Nixon closed the "gold window" in 1971, to be redeemed for gold.[49] In effect the U.S. Federal Reserve is the *world's* central bank permitting the U.S. to pay its debts using inflationary methods.

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[48]Keynes, 1920, p. 37. This statement was strikingly simiiar to the statement contained in the *Annual Report of the Governor of the Bank of Canada to the Minister of Finance and Statement of Accounts* for December 31, 1981 when the Governor spoke out against the effects of inflation which rewarded "handsomely the activities that contribute little or nothing to economic output at the expense of those who concentrate on productive effort." p. 6.

[49]For a powerful exposition on this problem see Michael Hudson, "Epitaph for Bretton Woods," *Journal of International Affairs*, Volume 23, No. 2 (1969), pp. 266-301 in which he argues that the rules of the game have been changed from a gold-backed reserve currency to a U.S. debt-backed reserve currency. See also his *Global Fracture: The New International Economic Order*, (New York: 1977).

To summarize: the movement away from a specie backed *domestic* monetary unit to legal tender, government debt backed currency underlines the grave responsibility placed upon the shoulders of the government as debtor and the central bank as a monetary creator. The creation and destruction of money is related to the fiscal requirements of the government (surplus and deficit position) and the monetary stance of the central bank, the latter's willingness or unwillingness to buy government obligations. The outcome of this complex and delicate tightrope act determines whether economic life, and hence political life, tends to be stable or degenerates into a process of gambling and speculation. There can be little doubt that the *politics* of this process is indeed a subject worthy of careful and critical analysis and evaluation by political scientists.

Public Debt and Responsible Government

In assessing his party's election victory on 14 October 1935, Mackenzie King noted, "The election (Mr King said) is an endorsation of the Liberal view that credit is a public matter, not of interest to bankers only, but of direct concern to every citizen."[50] The economy, it may be said, is too important to be left to economists and monetary technicians. Politicians, though an imperfect species, are at least periodically accountable for their decisions –economists and central bankers are obviously not. Attempts to shroud public finance behind a veil of technical and administrative jargon should be viewed critically. Responsible government implies that citizens have a right to be duly informed of the implications of policies which may threaten the financial integrity of the state and the currency in circulation. Any process of de–politicization of a crucial state function make it increasingly difficult to hold ministers and officials to account. Professor H.S. Gordon summarized this dilemma for democratic government when he noted:

> It has often been suggested that central banking activities must be shrouded in secrecy (and kept hidden many years after the event) if central banks are to do their work effectively, but this is merely a myth that has been perpetuated by the sub–culture of the financial world, and by the Bank of England in particular. Financiers, bankers, and central bankers have for a long time regarded themselves as a Pythagorean priesthood possessing the vital mysteries whose power is diminished if they are exposed to vulgar eyes. The desire for central bank independence springs more from this mythology than it does from defensible pragmatic arguments. It is a mythology that strikes at the roots of democratic government.[51]

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[50]"On Parliament Hill," *The Monetary Times*, 19 October 1935, p. 7.

[51] "Central banking and responsible government," in Cairns and Binhammer (eds.), 1965, p. 116.

In a democratic society, the legislature, in particular, and the taxpaying population in general, have the right to full, *relevant*, and up-to-date disclosure of current and prospective borrowing and how this may understate the true costs of current government operations. Concerns regarding this mounting governmental debt are heightened by historically high interest rates coinciding with the largest peacetime deficit ever adding to a massive and growing national debt. Today, interest payments consume over one-fifth of total federal government expenditure while borrowing currently represents one-third of government revenues. Also, it may be noted that *if* borrowing postpones current tax increases, incurring debts will affect the future tax burden of citizens.

From an institutional perspective increases in borrowing must be approved by Parliament. The political scientist may be interested in the *quality* of information provided parliamentarians as a basis for sound legislative decision-making.[52] It should also be pointed out that the long struggle between the legislature and the sovereign over the power to levy taxes frequently forced the latter to apply to the money lender to avoid incurring the wrath of legislators. A parallel case is seen to-day in the apparent preference of western governments to borrow, thereby postponing tax increases to avoid the indignation of electors.

Public Debt and the Class Structure

The holding of the national debt by a distinct class sharing readily identifiable national, regional, or religious interests may weaken the autonomy of the state. For instance, Henry C. Adams recounts that in the France of Louis Bonaparte the state-borrower and the banker-creditor "were separate only as legal personages."[53] The clear division between a well organized group of creditors and a mass of debtors may exacerbate class conflicts present in society, giving rise to demands for repudiation in favour of the majority as against a visible, propertied minority. The relative distribution or concentration of the national debt may also disclose a great deal about the influence of certain financial institutions in the economy. In Canada's case, during the 1930s, political and economic struggle was fundamentally a conflict between some governments

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[52] Norman Ward's classic study *The Public Purse: A Study in Canadian Democracy*, (Toronto: 1962) is preoccupied with the struggle between the parliamentary opposition (sometimes allied with the Auditor General) to force the Government to account for its expenditure of public funds.

[53] *Public Debts: An Essay in the Science of Finance*, (New York: 1898), p. 11.

representing a class of unorganized borrowers and a powerful, financial bureaucracy. Professor MacGregor has argued:

> The present conflict between governments and financial institutions is not in practice a simple conflict between debtor and creditor or labour and capital (though undoubtedly it arises from the fixed claims to income associated with certain forms of private property) but a conflict between governments and salaried trustees. These trustees who are officials of insurance companies, trust companies, banks, and investment banking companies constitute a small and powerful financial bureaucracy. It is their business to defend the assets under their administration and they may be expected to resist any adjustment of interest charges which is not forced upon them by overwhelming odds.[54]

In assessing this conflict it is necessary to scrutinize carefully the claims advanced by the financial press that it would be the small bank depositor, the hypothetical widow and orphan living off a pension, not the fat cats, that had the most to lose from repudiation of fixed income claims.

Another way of looking at the question of the distribution of the public debt is by asking the question *cui bono*? For the editors of *The Canadian Forum* in 1931 the matter could be reduced to "ninety-five per cent. of us have to foot the bill and five per cent. of us pocket the proceeds."[55] While class analysis is suggestive and promising as an analytical tool in exploring public debt, due to a lack of empirical data and the unique institutional character of debt holdings, this approach is eschewed for a more traditional approach which examines the respective goals of the key institutional participants in the debt management process. In the next chapter, the writings of various students of public finance are investigated with a view to establishing the basic assumptions and orientations taken by decision-makers during this time-frame.

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[54] D.C. MacGregor, "The Problem of Public Debt in Canada," *Canadian Journal of Economics and Political Science*, Volume 2, No. 2, (May 1936), pp. 186-187.
[55] "War Debts," *The Canadian Forum*, Volume 11, No. 131 (August 1931), p. 404.

II. TWO THEORIES OF PUBLIC DEBT

> The ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood. Indeed the world is ruled by little else. Practical men, who believe themselves to be quite exempt from any intellectual influences, are usually the slaves of some defunct economist. Madmen in authority, who hear voices in the air, are distilling their frenzy from some academic scribbler of a few years back.
>
> J.M. Keynes [56]

The objectives of this chapter are twofold. Firstly, two opposing schools of thought towards the nature and function of public debt are outlined. These two schools of thought are labelled the "burden" and the "benign" view of the public debt. This survey will cover classical and neo-classical political economy, and Keynesian writings on the subject up until the 1950s. These ideas are pursued in order to provide the reader with an understanding of the main theoretical assumptions and attitudes which influenced Canadian academics, bankers, and officials during the period. The second objective is to set out the assumptions and biases of Canadian academics, bankers, and officials on the nature of the debt. The chapter is organized into four sections; sections (i) and (ii) outline the burden and benign theory of public debts respectively. In Section (iii) a synthesis of these opposing points of view is developed by incorporating what appear to be areas of general agreement into a consistent theory. In the concluding section a brief examination of the views of Canadian academics,[57] bankers, and officials towards the public debt, government expenditure, and the new attitudes towards state deficit financing will be provided.

Before investigating the theoretical developments in the study of public debts and debt management, several crucial questions should be borne in mind. These questions are:

1. Can governments go bankrupt?[58]

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[56] *The General Theory of Employment, Interest and Money*, (London: Macmillan for the Royal Economic Society, 1973), p. 383.

[57] This will include the editors of *The Canadian Forum*.

[58] This question will not be dealt with further as the answer is an obvious "yes", although many economists and bankers take an ahistorical approach which yields a negative answer. For a scholarly account of the legal aspects of default and repudiation, see the two volume study published by the Yale University Press. Edwin Borchard, *State Insolvency and Foreign Bondholders Volume I General Principles*, (New Haven: 1951) and William H. Wynne, *State Insolvency and Foreign Bondholders, Volume II, Selected Case Histories of Governmental Foreign Bond Defaults and Debt Readjustments*, (New Haven: 1951). Interestingly, both Mexico and Peru are included in this latter study along with Bulgaria. Newfoundland's trusteeship, Alberta's repudiation or default and the numerous municipal defaults in Ontario and Quebec during the last depression are further illustrations of state insolvency.

2. Is public investment necessarily unproductive as classical economists supposed?

3. Are public debts fundamentally different in their origins and function than private debts?

4. What does "burden of the debt" mean?

Debt as a Burden

The central tenets of this school are:

1. Private and public debt are similar in nature.

2. Public debts imply a burden either in terms of the opportunity costs associated with the principal or future interest costs.

3. Associated with state indebtedness is a distinct social tendency or class whose function is to preserve the security of interest and principal.[59]

The implications for fiscal policy under this school would be highly conservative i.e. restrictive, in nature. There would be a strong prejudice against state intervention with a desire to keep the state's activities limited in scope. The burden theory is most closely associated with the writings of the classical liberal school of English political economy–Smith, Ricardo, and Mill. This antipathy to government borrowing and aversion toward state interventionism is best understood by remembering that during that epoch the government sector was rife with patronage, the selling of offices, and the granting of quasi–monopolistic trading privileges for the politically influential.[60]

Classical Tradition

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[59] The following organization owes a great deal to the formulation of respective positions on public debts by James Buchanan and his colleague Richard E. Wagner. (Buchanan, 1958; Buchanan and Wagner, 1967). Buchanan's seminal work, *Public Principles of Public Debt: A Defense and a Restatement*, brings into question the developing consensus in western economic theory that a rising debt is, to use Alexander Hamilton's words, "a national blessing." Buchanan, who may be properly be termed a classical liberal economist, discounts the view that public debts are intrinsically different from public debt, nor does he agree that a domestically held debt is fundamentally different from a externally held public debt. Along with the writings of classical political economists, cited hereunder, Buchanan belives a burden may result if and when the costs of public indebtedness exceed the benefits. For a contemporary exposition of the now generally accepted version of the benign theory of the public debt, see Paul A. Samuelson and Peter Temin, *Economics*, Tenth Edition, (New York: 1976), pp. 366–372. An earlier draft of this chapter included a description of Buchanan and Samuelson and Temin's views. This section has been dropped in order to focus more narrowly on the theories then dominant during the period under examination.

[60] See Jesse Burkhead's fine account of the intellectual history of the balanced budget, "The Balanced Budget," *Quarterly Journal of Economics*, Volume 68, No. 2, (May 1954), p 193.

For Adam Smith, public debts emerge when commercial enterprise becomes widespread allowing sovereigns to spend rather than hoard their treasuries.[61] Generally, public indebtedness was thought unwise though it could be necessary in the event of war.[62] In tracing the development of England's national debt, Smith noted the national debt "resembles the debts that a private man contracts upon account; and partly in a debt which bears interest, and which resembles what a private man contracts upon his bill or promissory note."[63] Thus, Smith saw no basic difference between private and public indebtedness– both were to be avoided, if possible.

Smith maintained that the accumulation of public debts, like private debts, would eventually lead to bankruptcy– bankruptcy which might be staved off temporarily through the expeditious debasing or the adulteration of coins, etc.[64] This tendency, Smith notes, has led to the earmarking of certain revenues to meet the interest on the debt e.g. excise, customs duties in the interests of creditors.[65]

With respect to the burden of the national debt, or passing costs forward in time, Smith stated in reference to wartime borrowing that future tax increases do result. "The return of peace," Smith wrote, "indeed, seldom relieves them from the greater part of the taxes imposed during the war. *These (taxes) are mortgaged for the interest of the debt contracted in order to carry it on."*[66] In short, borrowing did impose costs in the form of increased taxes to be borne by taxpayers sometime in the future.

Smith therefore rejected the notion of public debt as a "national blessing." Capital advanced to the government in return for a "government annuity", does not, in itself, add to the nation's wealth. Rather it is "only a capital withdrawn from certain employments to be turned towards others."[67] Besides encouraging profligate spending, borrowing was unsound in macro-economic terms for, by definition, the employment of funds by the state was wasteful and "unproductive."[68]

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[61] *An Inquiry into the Nature and Causes of the Wealth of Nations*, (New York: 1937), Book V, Chapter III, pp. 860–861.
[62]Smith, 1937, pp. 861–862, 873–876.
[63]Smith, 1937, pp. 863–864.
[64] Smith, 1937, p. 882.
[65]Smith, pp. 864–867.
[66]Smith, 1937, p. 872.
[67]Smith, p. 877.
[68]Smith, pp. 877–878.

David Ricardo, like Smith, regarded public debts as damaging to the health of the nation's economy. In the first place, there was the danger that in borrowing, the taxpayers delude themselves into thinking that they are meeting all the costs of government– the information problem.[69] Secondly, public spending was basically unproductive. "Taxes which are levied on a country for the purpose of supporting a war, or for the ordinary expenses of the State, and which are chiefly devoted to the *support of unproductive labourers, are taken from the productive industry of the country.*"[70] Hence, the real burden of the national debt arose not from future tax levies applied to meet debt interest charges, but from the *full principal of the loan.*[71] In a footnote referring to French economist J.F. Melon, the point is made that capital is 'annihilated' by state borrowing which gives rise to a future income stream recirculating moneys from taxpayers back to the state creditors.[72] This is our first encounter with the notion of public debts as self–cancelling entries on the national ledger, a position elaborated on by Pigou and later by Abba Lerner. For Ricardo, the burden of the public debt is the *principal* sum appropriated – the opportunity cost of the borrowings, not the interest paid on the debt.

To John Stuart Mill, the issue boiled down to :

> a choice between a great sacrifice at once, and a small one indefinitely prolonged. On this matter it seems rational to think that the prudence of a nation will dictate the same conduct as the prudence of an individual; to submit to as much privation immediately, as can easily be borne, and only when any further burthen would distress or cripple them too much, to provide for the remainder by mortgaging their future income. It is an excellent maxim to make present resources suffice for present wants; the future will have its own wants to provide for.[73]

Mill, like Smith, argued that *in principle*, public debts were comparable to private debts and common sense dictated that the state, like the indivudual, be prudent in its borrowings. Yet Mill did allow that as the general prosperity increased, there would be little harm done by financing current expenses through borrowing; interest and principle could be paid by

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[69] *Principles of Political Economy and Taxation*, R.M. Hartwell (ed.), (Harmondsworth: 1971), pp. 254–255. This informational problem is raised by subsequent writers including Adams and Buchanan.
[70]Ricardo, p. 252.(emphasis added)
[71]Ricardo, p. 252. See also Mark Blaug, *Economic Theory in Retrospect*, (Homewood, Ill.: 1970), p. 139 and Buchanan, 1958, pp. 43–46 for a discussion of this debate.
[72]Ricardo, p. 252n.
[73] *Principles of Political Economy with some of their applications to Social Philosophy*, Donald Winch (ed.), (Middlesex: 1970), p. 233.

posterity.[74] Mill also recognized the practical problems of repaying the debt, especially war loans, off all at once. The sudden diversion of tax revenues was viewed as potentially devastating for the economy.[75] Mill's position was a moderate one, that borrowing be discouraged to be resorted to but only under special conditions.

While Karl Marx produced no systematic treatment on money or on public debts in his economic treatises, he resembled his predecessors in adopting an essentially *normative* position on the subject. In dealing with the "genesis" of industrial capital, Marx parenthetically spoke of the public debt as "one of the most powerful levers of primitive accumulation."[76] In the same passage, he argued that public debt is little more than the fodder on which a "class of lazy annuitants" feeds giving rise to the pernicious practices of "stock-exchange gambling and the modern bankocracy."[77]

In "The Class Struggles in France", he observes "the faction of the bourgeoisie that ruled and legislated through the Chambers had a *direct interest in the indebtedness of the state*."[78] Thus, public debt was a potential means of enrichment for speculators i.e. politicians and their associates. Important too was Marx's "iron law of rising taxation" which identified the cumulative effects of a policy of continued borrowing by the state.

> the raising of taxation caused by the accumulation of debts contracted one after another, compels the government always to have recourse to new loans for extraordinary expenses. Modern fiscality, whose pivot is formed by taxes on the most necessary means of subsistence (thereby increasing their price) thus contains within itself the germ of automatic progression. *Over-taxation is not an incident, but rather a principle.*[79]

Classical political economy regarded the public debt negatively in normative terms. Indebtedness was poor economic policy for both the individual and the state, therefore the implication was that both private and public debts shared certain things in common. There was general acceptance of the principle that governments squandered resources and therefore borrowing should be kept to a minimum. While there was some

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[74] Mill, p. 233.
[75] Mill, p. 234. Jesse Burkhead states that Mill favoured public borrowing for two additional reasons. Firstly in the case of available foreign funds seeking a guaranteed return and secondly idle domestic capital liable to be sent overseas. Burkhead, p. 199.
[76] *Capital Volume I*, (New York: 1973), p. 754.(emphasis added).
[77] *Ibid*. p. 755.
[78] in Karl Marx and Frederick Engels, *Selected Works Volume I*, (Moscow: 1973), p. 207. (emphasis added)
[79] Marx, *Capital Vol I.*, p. 756. (emphasis added).

disagreement over the location of the actual "burden", there was consensus that a burden did exist, a burden paid immediately via the opportunity costs associated with public borrowing or through taxes imposed in the future. Furthermore, as Burkhead points out, there were important political overtones linked to government borrowing. To the classical liberal, deficit finance expanded the state sector relative to the taxpaying public and with it grew the potential for "irresponsible governmental action."[80] Aside from these comments of Marx, there was little discussion about the establishment of a specific class who held a vested interest in the continuing indebtedness of the state.

Here it may be noted that the classical exposition of the "burden" theory remains seductive in its simplicity. Public finance, according to the maxims of Mill and Smith may be reduced to a type of domestic economy, of balancing household accounts, easily understood by the layperson. Surely, it is argued, bankruptcy will inevitably occur if governments carry on deficit financing That is, if bankruptcy pursues business and the individual, the state too must be subject to the same constraints. This all too straight-forward world view recommended the abolition of wasteful state expenditures and paying off of war debts. Such simplistic prescriptions, though, fail to take into account the timing problems associated with receipts and disbursements of public funds and the financing of massive capital projects with long-term payback periods.

Neo-Classical Tradition

The first comprehensive treatment of public debts in the English language was a study entitled *Public Debts: An Essay in the Science of Finance* authored by Henry C. Adams and first published in 1887. Adams, a Professor of Finance at the Universities of Michigan and Cornell, may be rightly termed a fiscal conservative with leftist leanings. Adams saw growing public debts as the product of two ideas "distinct in their origin yet harmonious in their working" – nationalism and socialism.[81] Nationalism resulted in heavier expenditures on the militia,[82] while socialist ideas gave impetus to state expenditures on parks, public schools, post offices, railroads, etc.[83]

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[80] Burkhead, p. 204.
[81] Adams, 1898, p. 14.
[82] Adams, pp. 15–16.
[83] Adams, p. 17. Such ideas are found in the writings of the nineteenth century German economist Adolph Wagner (Wagner's Law of Expanding State Activity). See Richard M. Bird's account in *The Growth of Government Spending in Canada* , (Toronto: 1971), Chapter 4. This too is suggestive of recent work by James O'Connor. O'Connor hypothesizes two contradictory functions performed by the state– accumulation and

Adams detected four problems that could be associated with public debts in a constitutional, democratic order. Firstly, there existed an informational problem alluded to earlier by Ricardo.

> A loan calls for no immediate payment from the people, but produces vast sums for the government. It requires a certain degree of thought to recognize that debts imply burdens, and for this reason a government that resorts to borrowing may for a time avoid just censure. Loans do not, like direct taxes, demand a visible payment from the people; nor like indirect taxes raise the price of consumed articles.[84]

Second, like Marx, Adams argues there is a specific *class interest* associated with public borrowing.[85] Referring to the situation in France during the Napoleonic Wars, he notes that the borrower (i.e. the state) and the lenders, the banks "were separate only as legal personages."[86] In this situation a true, arms-length market relationship cannot flourish because the lender has control over the actions of the borrower. State indebtedness then becomes a pernicious instrument of a particular economic class. Adams also claimed that debts, while not creating new fortunes, do represent the basis for a distinct class interest.[87] This bondholding class is not the group of hypothetical young orphans and older widows, an argument often used to justify public debts as a sort of charitable undertaking. Instead, Adams found the bondholding class was relatively small and geographically concentrated in New York and New England. Adams stated that while "we may not say public debts bear with them a distinct and independent social tendency, it is yet true that they exert a social influence in *rendering permanent such class relations as spring from disparity of possessions, and that they introduce conflicting interests between citizens."*[88]

Third, public debts weaken the sovereignty of small states. Adams cited Egypt's debts to England in the 1860's and France's claims on Tunis in the 1880's.[89] The controls exercised by foreign "trustees" may be likened to the powers wielded by I.M.F. officials to-day when smaller states become embarrassed financially. With great prescience,

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[83](cont'd)legitimation. The latter is quite compatible with Adams' discussion of socialistic influences. *The Fiscal Crisis of the State*, (New York: 1973).
[84]Adams, p. 24.
[85]It should be noted that Adams was familiar with Marx's economic writings having read *Capital Volume I* in a French translation. See Adams, p. 8n.
[86]Adams, p. 11
[87]Adams, p. 41.
[88]Adams, p.50.(emphasis added).
[89]Adams, pp. 25-35.

Adams predicted the mounting influence of external money–lenders, namely New York banks, over Latin American states, would have profound political ramifications.[90] From this we may infer that external debts are quite different from internally held debts, a position shared with the "benign" school.

And finally, in Adams' treatment of war finance (the American War of 1812–14 and the Civil War), he concludes war finance should be based on both *increased taxation and increased borrowing*. Reliance solely on taxation would weaken the economy and the population's resolve to carry on the fight. On the other hand, heavy borrowing, based on the American experience, showed the dangers of rising interest rates and the unsatisfactory depreciation in the worth of government paper issued to finance the war.[91]

Professor Adams contribution is extremely important for his latent class analysis argues lucidly for a *political* understanding or analysis of the phenomenon of public debt. His political economy anticipated many future debates including the diplomatic complexities of international debts, the problems of concentrations in the distribution of the debt, and the political advantages in avoiding current taxes through borrowing.

The writings of the Irish student of public finance, C.F. Bastable must also be mentioned. Bastable falls into the burden of the debt school that maintains borrowing mortgages future taxpayers. "From a purely financial point of view," Bastable wrote, "the source is immaterial. In any case it is an immediate relief to the taxpayers, counterbalanced by greater charge in the future."[92] Bastable also saw the growing internationalization of finance and argued that the difference between internal and external debts would diminish with this process putting him in agreement with Buchanan.[93] Nevertheless, like Adams, he stressed the political complications of such forms of international indebtedness.[94]

American Reaction to the New Philosophy

In response to Keynesian–inspired teachings which did not treat public debt as a plague or economic disease, a debate soon raged in America during the war and post–war era respecting the merits of an ever–expanding public debt. For some American

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[90]Adams, p. 38.
[91]Adams, pp. 105–142.
[92]*Public Finance*, (London: Macmillan, 1917), p. 679.
[93]Bastable, p. 679.
[94] Bastable, p. 680.

academicians this new orthodoxy heralded a period of unrestrained government spending and inflation. The critics of the new, benign school framed their attack in both political and economic terms. On the political side, these academics reasoned that democratically elected governments could not be trusted and the state sector would grow too large given a philosophy which viewed public debt as a catalyst for economic growth. Harold G. Moulton in a monograph entitled *The New Philosophy of Public Debt* charged:

> With unlimited debt expansion we cannot prevent inflation without the use of totalitarian methods of control. No compromise or half-way measures can adjust the difficulties. *The choice is between regimentation and inflation.*
>
> The foregoing analysis serves to disclose the greatest danger with which the United States is now confronted. Unable or unwilling to perceive basic inconsistencies, or to choose between clear-cut alternatives, we drift toward the deep financial waters from which there is no return other than through repudiation in one form or another.[95]

A similar apocalyptic impression is left when reading H.L. Lutz's denunciation of deficit financing in the "Preface" to his Fourth Edition of *Public Finance*. Writing as the McCarthy witch-hunts began, Professor Lutz countered head-on the delusions of allegedly socialist-leaning economists. Spending proposals for social security, he believed, would cause free men to become prisoners of the state. "Instead of presenting spending, taxing, and borrowing as the way to an abundant life," Lutz went on, "this book says, in substance, 'There is no free lunch.: It says that we can have abundance, but we must first produce it'."[96]

Economic criticisms levelled against the new philosophy were founded upon investors' expectations of rising levels of taxation. B.U. Ratchford, like Moulton, argued that mounting debts would precepitate future tax increases which would lead in turn to a choking off of investment required for growth.[97] The debt burden would act as a powerful factor of uncertainty which would adversely affect that all important climate of "investor confidence". Though the debt servicing charges might remain small when compared to the G.N.P., small tax rises could nibble away at business profits.[98] Further, Ratchford pictured a vicious spiral of heavier, unproductive public investment, a large rentier class and cutbacks

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[95] Moulton, pp. 88-89. Another memorable quotation is found at page 91. Moulton notes the fear of "a drift toward an ever-expanding scale of public expenditures and of public enterprise (continues) - *even though there may be no responsible groups in the United States in favour of collectivism.* (emphasis added).

[96] *Public Finance*, Fourth Edition, (New York and London, 1947), p. v.

[97] "The Burden of the Debt," *American Economic Review*, Volume 33, No. 3, (September 1942), p. 458.

[98] Ratchford, pp. 460-462.

on *social expenditures* in order to meet these fixed interest charges imposed by the existing debt.[99] He further alluded to the technical problem of price support which became critical in the post-war period. In the event of falling bond prices (rising yields), the banks would face heavy capital losses, losses which would have to be borne by the Federal Reserve System.[100]

Benign Theory of the Debt

The central elements of the "benign" theory are summarized below:

1. Private and public domestically held debts are not comparable.
2. No burden is shifted unto future generations. While the responsibility to meet interest payments remains, the bonds themselves are passed from one generation to the next.[101]
3. External debts imply a burden which must be serviced from future revenue sources. [102]

The first main exponent of the position that a domestically held debt is qualitatively different from a private debt was Professor A.C. Pigou. Pigou in *A Study of Public Finance* claimed:

> Whereas the individual we have been imagining owes the whole of his debt to other people, *the British nation owes the predominant part to itself.* So far, no doubt, as it is indebted to foreigners, its position is analogous to that of an individual debtor. But, so far as it is indebted to British citizens– and it is this aspect of the debt with which we are here concerned– its position is quite different.[103]

Keynes and the Keynesians

Keynes' theoretical edifice rested on the notion of what was to become 'demand management' prescriptions. The way out of the periodic crises of high unemployment, deflation, and underinvestment lay in increasing 'aggregate demand'. As David McC.

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[99]Ratchford, pp. 462–463 .
[100]Ratchford, p. 465.
[101] Alvin Hansen, *Fiscal Policy and Business Cycles*, (New York: 1941), p. 142.
[102]On the question of the distribution of the debt, the benign theory is generally silent for interest payments are regarded as "transfer payments". These transfers are channeled through the state from general revenues to bond holders. As these payments are subject to tax, concentrated holdings are not seen as problematic. Still, in Canada, a whole host of "tax incentive" programmes permit the tax sheltering of literally billions of dollars in investment income including interest from federal goverrnment bonds and treasury bills.
[103]Second Edition, (London: Macmillan & Company, 1929), pp. 290–291.(emphasis added) This view was echoed some fifteen years later by Abba P. Lerner in his influential book *Economics of Employment*,(New York: 1951), p. 272. See also Samuelson and Temin, 1976, pp. 371–372.

Wright perceptively noted, Keynes placed great store on the *propensity to consume* and less on the *marginal efficiency of capital*.[104] Thus consumption in the Keynesian world tends to be exaggerated to the neglect of the factors influencing *production*. What Keynes was particularly interested in was 1) how could increased aggregate demand be *financed*, and 2) what were the *political* implications of the new theory?

The financing of consumption would be through the establishment of a somewhat progressive system of taxation and through borrowing when necessary. Growth of wealth, Keynes held, may be inhibited by the savings of the very rich, a prime source for tax revenues, hence the rationale for moderate redistributive policies.[105] For an answer to the second question, we turn to the "Concluding Notes on the Social Philosophy Towards Which the General Theory Might Lead". Keynes saw the demise of the *rentier* class and the ascension of the "executive skill of the financier... to be harnessed to the service of the community on reasonable terms of reward."[106]

> I conceive, therefore, that a *somewhat comprehensive socialisation of investment* will prove the *only means* of securing an approximation to full employment; though this need not exclude all manner of compromises and of devices by which public authority will co-operate with private initiative. But beyond this no obvious case is made for a system of state socialism which would embrace most of the economic life of the community. *It is not the ownership of the instruments of production which is important for the state to assume.* If the state is able to determine the *aggregate* amount of resources devoted to augmenting the instruments and the basic rate of reward to those who own them, it will have accomplished all that is necessary.[107]

This passage is suggestive of the type of "indicative planning" implemented by Monnet and the French government after World War II. Reading the passage "somewhat comprehensive socialisation of investment", it seems safe to suggest that Keynes' recipe was far more radical than what his disciples eventually would implement. Stripping away the qualifications, finance would be extensively regulated or nationalized to enable the state to direct the flow of credit and capital to various economic sectors.[108]

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[104] "Mr. Ratchford on the Burden of a Domestic Debt," *American Economic Review*, Volume 33, No. 1, (March 1943), p. 117.
[105] Keynes, 1973, p. 373.
[106] Keynes, 1973, pp. 376-377.
[107] Keynes, 1973, p. 378. (emphasis added).
[108] A.F.W. Plumptre, one of Keynes' students viewed the late British peer as a kind of saviour of modern day capitalism. "He saw clearly that in England and the United States during the nineteen-thirties, the road to serfdom lay, not down the path of too much government control, but down the path of too little and too late. Continued unemployment meant socialism, complete government control, unlimited government intervention. He tried to devise the minimum government controls that would allow free enterprise to

But why did Keynes himself consider "the foregoing theory (is) moderately conservative in its implications"?[109] In 1983, the hint of substantial public ownership of banks etc. in England or North America, would be considered radical, if not bolshevistic. Still, in 1936 the wholesale expropriation of private property, could not be dismissed as revolutionary romanticism. And, as discussed below, Robert Bryce, a student of Keynes' at Cambridge recommended the "conscription" of Canadian wealth to finance the war in 1942.

Before becoming advisor to the British Treasury during World War II, Keynes was deeply concerned about the effects of the inflationary financing of the war as well as the need to reduce consumption to a minimum. On inflation, Keynes, paternalistically spoke on the workers' behalf, arguing for a system of compulsory savings. Forecasting that the practical limits of taxation would soon be reached, Keynes proffered a scheme of forced savings which was, in practice, a form of deferred consumption.

> It makes all the difference in the world to each individual personally whether the excess of his income over his consumption is taken from him by tax or by loan. To him personally Government stock is an addition to his wealth, to his security, and to his comfort in facing the future. It gives him a claim over the future resources of the community.[110]

This form of compulsory savings was to be a progressively graduated system with those at the bottom of the income pyramid exempted while those at the top would be forced to save a higher percentage. Keynes proposed that these savings would earn 2.5 per cent interest per annum and be released in instalments during the "first postwar slump."[111] Keynes rationalized this scheme on the assumption that even if the lower and middle income classes wished to spend their current incomes, the Government would either tax their earnings away or rising prices would effectively erode disposable income of those previously without adequate purchasing power. He also believed "there will be great social advantages in spreading the inevitable increase in the National Debt widely among every class in the community.[112]

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[108](cont'd)work. The end of laissez-faire was not necessarily the beginning of communism." "Keynes in Cambridge," *Canadian Journal of Economics and Political Science*, Volume 13, No. 3, (August 1947), p. 371.
[109] Keynes, 1973, p. 373.
[110]"How to Pay for the War," in Donald Moggridge (ed.), *The Collected Writings of John Maynard Keynes, Activities 1939-1945*, Volume XXII, (London: 1978), p. 45.
[111] *Ibid*, pp. 48–49.
[112]*Ibid*, p. 51.

Keynes' thought was carried to America and brought to fruition in the writings of Alvin Hansen, a Harvard economist. In his influential *Fiscal Policy and Business Cycles,* Professor Hansen argued

1. Private and public debts are not comparable.[113]

2. No burden is shifted unto future generations. While the responsibility to meet interest payments remains, the bonds themselves are passed from one generation to the next.[114]

3. The public debt is an instrument of public policy, and as such becomes a mechanism for manipulating national income and the distribution of wealth.[115]

4. Debt financing is not inflationary as long as governments borrow from *current* savings.[116] Hansen rejected the view that costs could be passed on to another group of taxpayers.

Abba Lerner, a noted American Keynesian also emphasized the distinction between private and public debt. In his widely read *Economics of Employment,* Lerner stated:

> It is true that "we" in this statement are not the same people as the "ourselves". Some of us owe some of the national debt to other citizens, and we shall consider some of the important effects of this in the present chapter. But it is still true that as a nation we *do* owe the debt to ourselves. This is why the analogy with private debt is inapplicable.[117]

Corroborating Hansen and Lerner's optimistic projections were those of Eusey D. Domar of the Federal Reserve Board. In a paper published in 1944, Domar, using a 300 year time series projection, calculated the percentage of tax revenue required to service the public debt.[118] By manipulating the percentage of national income borrowed and the rate of growth in national income, Domar asserted that the problem could be reduced to "a problem of an expanding national income."[119] As a consequence, governments were urged to take an active role in such fields as education and health; these expenditures would raise national income through multiplier effects (consumption by public servants and a healthier, better educated work force).[120]

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[113] Hansen, p. 140.
[114] Hansen, p. 142.
[115] Hansen, p. 185.
[116] Hansen, p. 172.
[117](New York: 1951), p. 272.
[118] "The Burden of the Debt and the National Income", *American Economic Review,* 34, no. 4 (December 1944), pp. 799–823.
[119] Domar, p. 806.
[120] Domar, p. 820.

Synthesis and Recapitulation

An internally consistent theory of the public debt must be capable of distinguishing between "private" and "public" debts, and, at the same time, be sensitive to the meaning of "debt". While a corporation is an ongoing legal entity without a terminal date, the power of the state to expropriate makes the government a very different legal entity. The state can only be "expropriated" through social revolution or through military defeat. Secondly, a national debt, payable in the nation's own currency is always secure because the state possesses taxing powers, the ability to manipulate purchasing power and to compel citizens to accept payment in paper or debased coin as opposed to specie. As Emerson P. Schmidt in his examination of private and public debts noted: "It is not the dissimilarity between private and public debt, which is significant; rather public authority backed by the taxing and other sovereign powers can manipulate purchasing power and resources in ways which are not open to private enterprise."[121] This "manipulation of purchasing power" entails the capacity of the central bank to control the price level through the expansion and contraction of the money supply. This creative power is associated with the state's sole monopoly over the note issue. Therefore, public debts of those governments who can manipulate purchasing power, are generally regarded as "risk-free", unlike private individuals. Internally held debts of the national government are secure except in the event of social instability, etc. To be sure, the wise investor may not want to hold Brazil cruzeiro-pay assets guaranteed by the government of Brazil. Still, they are comparatively safe when compared to Brazil government debt paid in U.S. dollars for Brazil may be unable to accumulate sufficient foreign exchange to meet its debt payments.[122] As Brazil cannot control the printing press of another nation, in whose currency its foreign debts are denominated, Brazil may be unable to service its foreign debts.[123] The question of internal versus external debts really boils down to the investor's assessment of whether the borrower is earning enough foreign exchange to service the debt. Therefore, it is not so much a question of where the debt is held but rather a matter of how the medium of payment originates.

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[121]"Private *versus* Public Debt, *American Economic Review*, Volume 33, No. 1, (March 1943), p. 121.
[122]See the Associated Press report, "Brazil delaying some payments," *The Globe and Mail*, 19 March 1983, p. B3.
[123] On the exchange rate risks provincial governments are exposed to see Robert M. Dunn, Jr., *The Canada-U.S. Capital Market*, (Montreal: 1978), pp. 103-105.

Yet private and public debts share one important thing in common, they represent a "promise to pay." Certificates of indebtedness are traded and normally the law of supply and demand applies. That is to say, debts, private and public, will rise and fall in value according to the supply of, and demand for, those particular debt instruments. Although the government may ultimately control the printing press, in a mixed economy the prices of bonds are determined largely by market expectations, the supply of funds going into the market and the variety, supply, price and nature of competing debt instruments.

Internal and external debts are similar in the case of sub-national governments which are incapable of manipulating purchasing power. *National* internal and external debts are of quite a different character for the national government must acquire or earn foreign exchange to meet interest payments. This may be a problem when certain commodity prices i.e. oil, fall. Repaying a domestically denominated debt is not problematical for one always has eventual recourse to the printing press and/or levying taxes.

On the question of passing the debt burden forward in time, the literature reveals a debate on question of the opportunity costs of borrowing or the future stream of interest charges that society must pay. In our view, the burden may be passed forward in time if one of the following three conditions hold. (1)If money is borrowed at above-market rates, the interest premium paid will imply a burden. (2) If borrowing "crowds out" productive capital investment with identifiable rates of return when demand for credit is high, the premium associated with this phemonenon adds to the future debt burden. This is most marked when borrowing by the state is to finance *operating* as opposed to *capital* projects. (3) If the future costs of borrowing discounted to their present value exceed the present value of expected future benefits derived from the investment, a burden is passed forward in time.

It should be noted that this theory does not preclude the insolvency of states. On the contrary, a state which ceases to pay its debts to *external* creditors becomes, in the eye of international capital, bankrupt. A national government which holds a monopoly over the use of "legitimate coercion", can always pay its *internal debts* by legislating the acceptance of its I.O.U.s. Yet even with this monopoly, history is full of illustrations of peoples recognizing this process of confiscation and readjusting prices accordingly.

While the state continues to pay its internal debts through a form of currency inflation it produces a socio-economic process which *may* foster social revolution. When this confiscatory process directs attacks the economic security of the middle classes, the legitimacy of the political and financial orders, which are so interdependent, is undermined.

The Canadian Discussion

In this section, the views of Canadian academics, bankers, and officials on the nature of public debt and government finance, in general, are summarized. Not surprisingly, bankers held steadfastly to a burden view of public debts whilst officials and academics gradually came to accept a macro-economic, benign view of the debt. It should be noted that the attitudes of academics, bankers, and officials to public debt was influenced by the swirl of controversy over the creation of a central bank and the fears of currency inflation then developing. The comments of University of Manitoba economist, D.A. MacGibbon give some indication of the conservative orientation of academics at this time:

> Past inflations characteristically have been of the involuntary type arising chiefly from the inability of governments to levy sufficient taxation to meet current expenditure. In this position they have first borrowed, *a proceeding involving a growing burden of interest charges*. This tended to widen the gap between revenue and expenditure. Finally as a *pis aller* they had to resort to inflation. A's Von Mises points out: "A government always finds itself obliged to resort to inflationary measures where it cannot negotiate loans and dare not levy taxes.[124]

This attitude was shared by many bankers who doubted the reliability and honesty of governments with access to the printing press. Fairly typical of the views of Canadian bankers were the comments of Canadian Bank of Commerce President, Sir John Aird, recorded below:

> The Bank of Canada opens, then, at a time when there is almost world-wide tendency on the part of governments to use such an institution as a medium of currency inflation to meet recurring budget deficits. The public of Canada will look with confidence to the chief executive officers of the new Bank to protect its administration *from all attempted political interference on the part of governments* which would weaken either our currency or our public credit, and to avoid hazardous commitments with foreign institutions or dangerous participation in extensive exchange stabilization operations which might result in a most serious impairment of the Bank's resources.[125]

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[124]"Inflation and Inflationism," *Canadian Journal of Economics and Political Science*, Volume 1, No. 3 (August 1935), p. 330.
[125]Canadian Bank of Commerce, *Annual Report, 1934*, p. 29. (emphasis added)

This view is similar to more recent "neo-Conservative" writings on the subject that hold government reponsiveness to the electorate's desire for expensive programmes produces a deeply rooted, inflationary tendency. These and other remarks betray a deep suspicion of politicians' motives and a strong philosophical aversion to a growing state sector.

Academics

In this area, we have ample evidence demonstrating that Canadian economists were fiscally conservative preferring balanced budgets to public debts. A shift is discernable towards the end of the period when economists take a more macro-economic, systemic approach to the problem of the burden of the debt.

D.C. MacGregor, perhaps the most astute student of Canadian public finance at this time, took an apocalyptic view of the public finances during the 1930s. Highly critical of the timid, bankrupt, economic policies of Bennett's government based on the hopes of a U.S. led economic recovery, MacGregor remained skeptical about the value of a deliberate government deficit. MacGregor further doubted the capacity of a capitalistic economy to handle the debt charges incurred by the state.[126] The problem of the public debt arose from its "dead-weight" nature, that is, the interest and principal being paid were not offset against productive assets and the fixed interest charges which necessitated confiscatory taxation. Aggravating this dilemma was the distributional perversity of the debt which saw large sums diverted to a *rentier* class too timid to invest in new industries.[127]

To the University of Toronto economist the deflationary experience resulted in a gross inequality between creditors, whose claim on the national income had rapidly increased, and debtors whose share of national income had plunged precipitously. MacGregor argued for an innovative scheme which would reward creditors according to the growth of national income and the cost of living– a modern day indexing scheme or "preferred shares in a gigantic investment trust comprising the whole nation's activities."[128]

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[126]"Public Debt," in *The Canadian Economy and its Probelms*, H.A. Innis and A.F.W. Plumptre, (eds.), (Tornonto: 1934), pp. 56–57, "These Insignificant Budgets," *The Canadian Forum*, Volume 14, No. 166 (July 1934), pp. 386–389 and "The Threat of Financial Crisis," *The Canadian Forum*, Volume 13, No. 150 (March 1933), pp. 206–209.
[127]MacGregor, 1934, pp. 58–59.
[128]*Ibid*, pp. 59–60.

Although MacGregor was extremely critical of the inflexibility underpinning the debtor–creditor relationship which tended to be biased in favour of the creditor, he was unwilling to give much credence to those advocating an expansion of public debt as a panacea to world–wide depression. In rejecting the "we owe it to ourselves", benign theory argument, MacGregor opined:

> Theories which treat the service of internal debt as no more than a collection of offsetting book entries are valid only on the assumption that the economy has fully adjusted itself to the associated burden of taxes, that there are no distributional effects, and that the recipients of interest payments taken as a group continuously spend or invest for themselves, or loan to others who are spending or investing without preference for gilt–edged investments, an amount equal to their current receipts from the government. The weakness of such assumptions is evident in the local and provincial finance of debtor areas dependent on exports.[129]

In other words, the utilization of the benign theory to underwrite an expansionary budgetary policy was suspect in an economy characterized by dependency on outside capital. Nor was MacGregor unsympathetic in his writings to the views of Aberhart who ardently believed that continued indebtedness or "borrowing one's way out of debt" was not the way out from the depression.

> To a *limited extent* public borrowing tends to keep money in circulation and stimulate business, but it cannot in itself restore or even maintain the domestic price level, when the downward drag of low export prices, intensified by the small depreçiation of the Canadian dollar from gold works so powerfully in the opposite direction. *There is no good reason to believe that we can either borrow our way or squander our way into prosperity by public agency alone.*[130]

Seeing the damage done by an over–expansion of credit and the devastating wave of deflation made the Toronto economist wary about needless additions to the community's debt. MacGregor regarded the portion of national income devoted to interest payments as too high and a hindrance to economic growth.

Professor MacGibbon of the University of Manitoba, too, was cautious in his evaluation of the new philosophy of public debt. In reviewing Alvin Hansen's *Fiscal Policy and Business Cycles*, he expressed his reservations about the volume of the debt outstanding and the wisdom of an ever–rising national debt.[131]

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[129] "The Problem of the Public Debt in Canada," *Canadian Journal of Economics and Political Science*, Volume 2, No. 2 (May 1936), p. 173n.
[130] "The Threat of Financial Crisis," p. 207. (emphasis added)
[131] "Review Article: Fiscal Policy and Business Cycles," *Canadian Journal of Economics and Political Science*, Volume 9, No. 1 (February 1943), pp. 79–80.

War Finance

Public finance theorists were principally occupied with the twin problems of *inflation* and *abstinence from consumption* during wartime. In both the case of Canada and the United Kingdom, resort was made to central and commercial bank financing in the early months of the war to, in a sense, lubricate the monetary system for anticipated major financings. This procedure was defended on the basis of expediency– placing funds at the disposal of the state and to promote the growth of income and the mobilization of manpower. Bank financing would gradually be displaced as the various savings and loan organizations were put in place and as there developed the need to prevent rising national incomes from being spent on unnecessary, luxury items.[132]

Fears about inflation were justified based on historical precedents as heavy reliance on an expanded fiduciary note issue tended to be inflationary.[133] The problem of war finance reduced to developing a feasible, politically marketable, financial package which pushed taxation to the maximum, politically tolerable limits, encouraging the individual to purchase war bonds instead of unnecessary consumer durables, and minimizing the amount of bank financing.[134]

Rapidly rising prices experienced during 1940 and accelerating in 1941 soon focussed attention on methods to combat this economic disease. In October 1940, the editors of *The Canadian Forum* warned "If the government encourages credit expansion along the lines these lines (the financing of Victory and War Loans) we are starting down the inflationary path."[135] The following March they saw "no sign that Ottawa authorities (were) devising a way to cut down on our private expenditures or bold enough to compel

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[132] J.F. Parkinson, "Some Problems of War Finance in Canada," *Canadian Journal of Economics and Political Science*, Volume 6, No. 3 (August 1940), p. 423 and Keynes, 1978, "How to Pay for this War," pp. 63–64. "Borrowing from the banks on this scale is a once–for–all proceeding. It cannot be repeated in the second year. Having increased output 15 per cent in the first year, we could scarcely expect to increase it by a further 15 per cent in the second year; and having allowed an increase in the first year to correspond to an inevitable increase of costs here and abroad, it should be our object so to control consumption as to avoid repeating this movement in the second year. (Originally printed in the *Economic Journal*, December 1939.)

[133] C.A. Curtis, "The Canadian Banks and War Finance," in Neufeld, 1964, pp. 206–217 and F.A. Knox, "Canadian War Finance and the Balance of Payments, 1914–1918," *Canadian Journal of Economics and Political Science*, Volume 6, No. 2 (May 1940), p. 242.

[134] Donald Gordon, "Some Current Problems," *The Journal of the Canadian Bankers' Association*, Volume 47, No. 4 (July 1940), pp. 426–437. Gordon at the time was Deputy Governor of the central bank and Chairman, Foreign Exchange Control Board.

[135] "Inflation Approaches," Volume 20, No. 237 (October 1940), p. 196.

us to do so."[136] This criticism was consistent with their call for the imposition of a heavy, progressive tax on war profits accruing to Canadian industrialists in addition to the conscription of wealth proposed by the C.C.F. in 1940. The basic position held was those best able to afford to pay for the war should be made to do so and the editors advanced recommendations for a compulsory interest-free loan levied on those capable of providing their savings to the nation at war.[137]

Turning now to the issue of the burden associated with the contracting of these vast war debts, Professor McIvor noted:

> While it is true that under certain circumstances, future generations may be called upon to bear some of the real costs of a conflict e.g. through the dimunition of the productive capacity of the economy as a result of the war, *this occurence is obviously independent of the means in financing the conflict. It is surely apparent that the real cost of a war is incurred by using resources for purposes of destruction which would otherwise have been available for constructive ends.* The significance of the taxation-versus-borrowing controversy lies in determining how the burden of the present war will be distributed *within the existing generation*, and how the real income of future generations will be distributed among its own members.[138]

McIvor's position was not entirely consistent with Samuelson and Temin's assertion which states that the mode of financing is completely immaterial. Rather, McIvor emphasized the resource consumption/destruction aspects distinguishing this from the implications of financing the war appropriations by taxation and borrowing. However, his comment that the real costs of a war are destruction is a truism which does not negate the significance of the mode of financing which Samuelson and Temin mistakenly ignore. Yet, McIvor did acknowledge that a burden of the war debt is transferred to future generations through increased taxes required to service the debt.[139]

J.J. Deutsch in his investigation on the financing of the Great War held that it was not the financial method of acquiring physical resources which could be associated with the true burden; instead the burden was met out of current consumption- the

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[136]"War Finance," Volume 20, No. 242, (March 1941), p. 364. As usual, it was Mackenzie King who was vacillating not his advisers, Clark and Towers. See J.L. Granatstein, *Canada's War. The Politics of the Mackenzie King Government, 1939-1945*, (Toronto: 1975), p. 178.

[137]"The Keynes Plan," *The Canadian Forum*, Volume 20, No. 232 (May 1940), pp. 36-37 and "Conscription of Wealth," *The Canadian Forum*, Volume 20, No. 240 (January 1941), p. 300.

[138]"Canadian War-Time Fiscal Policy, 1939-45," *Canadian Journal of Economics and Political Science*, Volume 14, No. 1 (February 1948), p. 64. (emphasis added)

[139]*Ibid*, p. 92.

Ricardo-Samuelson and Temin thesis.

> The fact that the Government obtained the money from Canadians by means of loans instead of by taxation makes no difference in this regard. The food, equipment, and munitions used by armies had to be obtained either directly or indirectly from current production in Canada. There was no way of securing these immediately required materials from posterity.[140]

Again another truism. Of course, goods and services cannot be purchased which do not yet exist. Yet, it should be immediately apparent to any student of economics that heavy purchases of goods "on time" as opposed to purchases with cash have profound implications for the purchasing power of the state and the community down the line. Deutsch's thinking is important because it signalled a growing consensus in the economics profession that deficits and government borrowing were more or less "neutral" in their effects.[141]

Given the gradual ascendency of the macro-economic paradigm in conjunction with the domestication of roughly 97 per cent of the Dominion's debt by 1945, it is not surprising that the issue of the debt burden and the question of the inter-generational transfer of the debt burden would be forgotten because for the very first time "we owed it to ourselves." For instance, R.V. Anderson's review of post-war "full employment" prescriptions saw the burden debate becoming an analysis of "transfers" between individuals under the aegis of the state. In macro-economic terms, these transactions were regarded as self-cancelling and did not require deeper investigation. In moving away from a "public accounts", cash basis of accounting towards the more conceptual schema of national accounts, economists became interested only in possible "leakages" to foreign bondholders which represented a complete loss to the domestic economy. A secondary concern dealt with the distributional effects of payments to individuals with a lower propensity to consume. In short, the new paradigm discounted the central role of the national debt- an astonishing position in view of the sheer dominance of Dominion securities in Canada's capital markets simply because the debt remained mainly in the hands of Canadians.

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[140]Deutsch, 1940, p. 533.

[141]See R.V. Anderson, "Review Article: Policy for Full Employment," *Canadian Journal of Economics and Political Science*, Volume 12, No. 2 (May 1946), p. 199 and Parkinson, 1940, pp. 413-414.

It is often remarked that Canadians are a colonial people and this claim is often justified by pointing to the writings of Canadian scholars who borrow ideas liberally from abroad. An analysis of the writings of journal contributors reveals that Canadian academics did not endorse as whole-heartedly as their American confreres, the fiscal policy implications of the new, benign attitude to public debts. This conservative view, notwithstanding Mackintosh's work on the 1945 "White Paper", was maintained throughout the Clark period. Admittedly, their opposition to mounting public debts was not as shrill as that of some American writers (Moulton, Lutz for instance) and was not influenced in any great way by ideological antipathy to state investment. Rather, it was in the area of debtor-creditor relations that a distinctive Canadian political economy may be seen. This relationship made the Canadian academic acutely aware of the extreme vulnerability of Canada's economy, particularly of the staple exporting regions, and the urgent necessity for regulating currency and credit in the interests of the nation *as a whole*. Here, "sanctity of contract" was not viewed as the "be-all and end-all" of economic existence. This support for the underdog-debtor, based on considerations of equity and the economic requirement to increase consumption and national income, was also congruent with the notion that war sacrifices must be borne equally by labour and capital. In the matter of spreading these sacrifices, intellectual colonialism was evident as Keynes' compulsory savings' plan was greeted uncritically in both official and academic circles.[142]

If one could point to any coherent corpus of work on Canadian public debt, one must turn to the writings of Professor Donald Chalmers MacGregor. MacGregor deplored the lack of public debate on this subject and "the tendency of politicians and the public to cast around for a scapegoat,"[143] but never refrained from blasting the *rentier* class when he felt criticism was justified. MacGregor strongly believed that a legislative reduction of interest payments by the Dominion Parliament, modelled along the lines of the Australian enactment,[144] was necessary to retore the equilibrium between the debtor and creditor classes. His contributions to the debate lay in (1)identifying the nature of the classes in conflict, a powerful financial bureaucracy and a largely unorganized creditor class, (2)

[142] His views were predictably less well received by the editors of *The Journal of the Canadian Bankers' Association*."Mr. Keynes Compulsory Savings Scheme," Volume 47, No.3 (April 1940), pp. 256-259.
[143]"The Problem of the Public Debt in Canada," pp. 187-188.
[144] In 1931, the Australian Parliament passed legislation which reduced the internal rate of interest by 20 per cent on all public and most private debts.

analyzing public debt in relation to national income and the price level, and (3) his critical attitude towards indefinite "pump-priming" as the remedy for depression plagued economies.

The Bankers

Bankers shared the objections of the classical writers towards rising state deficits, public debts, and the inherent wastefulness of the state as an economic actor. Throughout the 1930s, speeches by bank officers at annual meetings were full of criticisms about bureaucratic waste and unnecessary duplication of services resulting in rising debts and burdensome levels of taxation. Sir Charles Gordon reminded shareholders of the Bank of Montreal in 1932 that the "weight of the public debt and taxation restricts trade"[145] and "there is a disposition in many quarters to look to the government, both local and federal, for bounty in one form or another, but it should be remembered that a government of itself produces nothing."[146]

One of the imagined sources of this profligacy was the duplication of government services by the three levels of government. In 1932, Sir Herbert Holt attacked "excessive" expenditures of governments and municipalities, warning "(T)here never was a time in our history when it was so necessary to avoid extravagance of every kind."[147] Holt again returned to this theme the following year, opining: "there is a noteworthy duplication of government in Canada which leads to the excessive costs of administration. We must seriously consider whether this country can afford to maintain as many as nine separate Provincial Governments, together with the Federal Government, each with an elaborate organization."[148] These comments not only reveal the bankers' support of a burden view of public debts but also a hopelessly naive expectation that governments should and could be conducted like a business.[149]

Another matter preoccupying Canada's "guardians of the temples" relating to government duplication was the demand by Canada's two largest banks for the amalgamation of Canada's transcontinental railways under the umbrella of the Canadian

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[145]Bank of Montreal *Annual Report, 1932*, p. 7.
[146]*Ibid*, p. 8.
[147]The Royal Bank of Canada, *Annual Report, 1931*, pp. 5–6.
[148]The Royal Bank of Canada, *Annual Report, 1932*, p. 6.
[149] For further comments of bankers on the prodigal behaviour of governments see F.A. Rolph, President, Imperial Bank of Canada, *Annual Report, 1931*, p. 16; Sir John Aird, President, Canadian Bank of Commerce, *Annual Report, 1935*, p. 35; J.A. McLeod, General Manager, The Bank of Nova Scotia, *Annual Report, 1933*, p. 23.

Pacific Railway. This monopoly would reduce costs to the Canadian taxpayer and increase returns to the C.P.R. shareholders. Sir Charles Gordon spoke of "the destructive competition between our two great railway systems" emphasizing "some form of co-operation must be worked out by which needless duplication of services will be avoided."[150] Sir Herbert Holt, supposedly Gordon's chief competitor, countered the charges of monopoly by stating, "such fear is groundless as under the present system all rates and services are regulated by law under the administration of the Board of Railway Commissioners, and there is no reason to suppose that a like supervision would not still continue."[151] Obviously it did not occur to Sir Herbert that just possibly such regulation was not always in "the public interest".

In sum, bankers believed in a limited role for the state and preferred, by and large, to lend money to farmers, to commercial and industrial concerns than to unproductive governments which squandered taxes and borrowed funds. The creation of a central bank in 1935 tended to validate the bankers' notions that government spending was out of control.

Another aspect of governmental activity which displeased the bankers in the 1930s and 1940s was the falling rate of interest. As will be shown later, falling interest rates were regarded in government circles as a *sine qua non* to economic recovery. That bankers should hold a less sanguine view of lower interest rates should come as no surprise because this meant lower interest earnings along with demands from agriculture and industry to renegotiate the rate of interest on loans. After several years of lower interest rates (which commenced in 1932) had not produced the promised recovery, criticism soon arose to the effect that lower rates penalized depositors, discouraged thrift and promoted government profligacy.[152] This presumed failure was also used by the banks to absolve themselves of responsibility for creating or exacerbating the Depression by withholding or withdrawing credit. According to the President of the Canadian Bank of Commerce, S.H. Logan:

> I think that most people now recognize that easier money will not cure our existing problems. Certainly substantial reductions in the interest rate on bank loans have not brought about any marked increase in borrowing. Action in

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[150]Bank of Montreal, *Annual Report, 1931*, p. 7.
[151]The Royal Bank of Canada, *Annual Report, 1933*, p. 3.
[152]See comments of General Manager A.E. Phipps, Imperial Bank of Canada, *Annual Report, 1935,*, p. 25.

> other areas is obviously required and monetary experimentation directed to further cheapening the cost of short-term money holds, therefore no hope of removing the remaining handicaps to complete recovery. [153]

This prejudice against low, short-term rates on the part of the banks is quite understandable given the liquidity preference of the industry. As Chapter VI illustrates, the bankers had a pathological fear that Dominion Government rates would be administered by the Government through the medium of the central bank at very low levels, and this would, in turn, drive down rates for other borrowers.

The reaction of the bankers to the evolution of a Keynesian-inspired, counter-cyclical economic policy does not seem to have been as shrill as that of conservative American acaedmics. Yet, the bankers were evidently wary of Canadians prediliction to vote for the "socialist" C.C.F. during the years 1943 and 1944. At that time, chartered bank shareholders were warned of the dangers of "bureaucratic control" leading ultimately to "a form of dictatorship and domination of the national economy, with capital, production and labour committed to whatever ventures, whether economic or political, a few leaders decide."[154] In a similar statement at about the same time, the General Manager of The Bank of Nova Scotia praised Canada's "competitive" banking system with its flexibility and protection of depositors and cautioned Canadians about the perils of a monopolistic, centralized banking system.[155] Such concerns prompted the Canadian Bankers' Association to publish, in 1945, a pamphlet entitled *A Background on Banking Theory* by W.T.G. Hackett to counter the arguments of socialists and Social Crediters.[156] This anxiety remained hight throughout the early post-war period and was counteracted by periodic reminders to Canadians that credit could be used against the people by unscrupluous political leaders for partisan purposes.[157]

The banks distrust of government spending and deficits was confirmed by the behaviour of governments in the Depression. Their criticism of expenditures was muted somewhat in the post-war period when it appeared that the programme for reconstruction had been successful. This brief survey also shows the acute sensitivity of

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[153]Canadian Bank of Commerce, *Annual Report, 1938,* p. 20.
[154]S.H. Logan, President, Canadian Bank of Commerce, *Annual Report, 1943,* p. 19.
[155]The Bank of Nova Scotia, *Annual Report, 1943,* pp. 25-26.
[156](Toronto: 1945).
[157]See remarks of Mr. Enman, General Manager, The Bank of Nova Scotia, *Annual Report, 1948,* p. 25.

bankers to low rates of interest and to unfavourable political developments which threatened the well-being of their private, financial institutions.

Officials

In this section, the views of G.F. Towers are examined based on his extensive testimony before the Commons' Standing Committee on Banking and Commerce. Unfortunately, the archival materials at the Bank of Canada and the Public Archives of Canada do not provide sufficient data on which to make an intelligent judgment on the views of Deputy Finance Minister W.C. Clark respecting public debts and the management of the debt.[158] Nevertheless, as Chapter V demonstrates, Clark strongly believed that the immediate lowering of interest rates was imperative in order for economic recovery to take place. Secondly, Clark was never hesitant to advance political arguments to justify a dropping of rates. Thirdly, Clark recognizing the problems of financing massive war deficits, always pushed for higher taxes when making recommendations to his Minister. Finally, the gradual shift in Clark's thinking is perhaps best revealed in the argumentation advanced by Finance Minister J.L. Ilsley in his 1944 budget presentation. In that particular budget, authored no doubt mainly by Clark and his subordinates, an elaborate rendition of the benign theory is offered.

Perhaps the best interpretation of Clark's economic philosophy was provided by one of Clark's senior policy advisors, R.B. (Bob) Bryce. In a tribute written shortly after Clark's sudden death, Bryce noted:

> On the whole, it seems safe to say that during the thirties Clark was little convinced by the arguments of economists in the States and Britain in favour of budgetary "prime pumping;" he was inclined to emphasize the importance of business and financial confidence together with such direct influence upon incentives as were found in the exemption of building materials from the sales tax in the 1938 budget, and the tax credits for capital expenditures introduced in April 1939.[159]

Social Credit members and Liberal monetary reformers like McGeer and W.A. Tucker anxiously looked forward to grilling Governor Graham Towers in the Spring of

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[158] Clark, unlike Towers, was less prone to put down on paper his recollection of conversations or meetings or his views on certain subjects in the form of a lengthy memorandum.

[159] R.B. Bryce, "William Clifford Clark, 1889-1952." *Canadian Journal of Economics and Political Science*, Volume 19, No. 3 (August 1953), pp. 418-419. This interpretation is generally in accord with the recent work of historian J.L. Granatstein on the development of policy in Finance and at the Bank of Canada during the 1935 to 1950 period. *The Ottawa Men: The Civil Service Mandarins, 1935-1957*, (Toronto: 1982), pp. 157-167.

1939. Towers' extensive testimony during March, April, and May of 1939 sheds substantial light on this official's view of public debt. It is apparent from his testimony that he inclined more towards a "benign", macro-economic approach to public debts than a classical, burden approach although there are elements of the burden school present in his testimony. Early in the hearing Towers, responding to Gerry McGeer's queries, showed some sensitivity to the *distributional nature* of the public debt.

> As the debts of the government are an asset of the Canadian people, I do not see much point in the thing; (reducing the outstanding debt) except that, to the extent that the government thinks that the distribution of those assets of the Canadian people– which are its debts– is unsatisfactory, it may take steps to remedy that distribution in any way that lies with the legislative power; in fact, in any way, I suppose– by income tax or succession duties or any other action it cares to take.[160]

Later, in an exchange with J.C. Landeryou, the Governor demonstrated his alliance to the benign school by associating economic progress with the growth of private and public debt– the Hamiltonian view of public debt as a "national blessing". This benign view is perhaps an outgrowth of the Bank and Finance Department's developing macro-economic approach to economic policy.

> Now there may be and there has been, an object in repaying debts so far as any one individual entity is concerned; but as it is repaid to the holders of the debt one must assume that they are using that money for fresh enterprises, involving fresh debts and fresh assets; so that all I can say is this, that in a country where the sum total of public and private debt was decreasing, you have a country which is going backward and which is becoming more poverty-stricken.[161]

Towers, however, did not hold the extreme position that the mode of financing government deficits was irrelevant and that government borrowing was entirely costless. While the "real cost" of government expenditure was its command over labour and equipment, the challenge was to acquire the money to "give title" to this labour and equipment.[162]

Towers also outlined, in his testimony, two circumstances in which he conceded that public debt would be burdensome. Firstly, an unequal distribution of the debt which leaves interest "to gravitate in certain directions" was one such source.[163] And secondly,

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[160]*Minutes of the Proceedings and Evidence of the House of Commons Standing Committee on Banking and Commerce* , 18th Parliament, 4th Session, No. 3, Friday, 31 March 1939, p. 80.
[161]*Ibid*, No. 9, Tuesday, 2 May 1939, p. 235.
[162]*Ibid*, No. 3, Friday, 31 March 1939, p. 64.
[163]*Ibid*, p. 79.

government borowing "for non-productive purposes or purposes that are less productive than the *alternative uses* to which the labour and capital would have been put," constituted another source of the burden to be borne by the taxpayers.[164]

In summary, Towers predictably rejected the monetary reformers' apocalyptic view of ever-mounting debts and the inevitability of repudiation. As the following quotation shows, the Governor took a broader and longer-term view of national debt in relation to the whole economy.

> As all the interest is paid to citizens of the country, the economy as a whole is not better off if interest charges are reduced, simply by virtue of the fact that they are reduced. It is better off *only if such redistribution of wealth as is involved in interest reduction enables the economy to function more efficiently*- relieves certain strains, and spreads sacrifices more widely.[165]

Once again the Governor refers to the distributional question: if the recipients of debt payments were not using these funds in an economically efficient manner, there would be some rationale for reducing interest payments. Yet as earlier statements show, a macro-economic perspective would produce policies to recoup from "coupon clippers" a part of their earnings and therefore these funds were never taken out of the economy.

Summary

During the Depression, Canadian academics, bankers, and officials shared the classical, burden view of the debt, this being consistent with the understanding of a limited role for the state. It should be remembered that the vast amount of patronage dispensed by both levels of government and the blatant purchase of votes in some provinces at that time did much to cultivate the perception of government as wasteful and inefficient. This limited role allotted to the state was soon superseded by the massive and relatively successful intervention of the Dominion in war-time. The drift towards Keynesian macro-economic policy was certainly made easier through the Liberal Government's response to political pressures emanating from the electorate which, in 1943 and 1944, was turning leftward. Thus, attitudes towards public indebtedness shifted ground to conform with the emerging social and economic philosophies in response to the changing exigencies of depression and war.

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[164] *Ibid*, No. 8, Friday, 28 April 139, p. 202. (emphasis added)
[165] Towers Memoranda, No. 119, 12 April 1938, *Bank of Canada Archives.*

III. THE ECONOMIC CONTEXT OF THE 1930-1952 PERIOD

The following examination does not purport to be an exhaustive or searching, analysis of the Canadian economy during the 1930–1952 period. Rather, an attempt is made to provide economic and financial data to establish the context in which debt management decisions were taken.

Prelude to Depression

By many indicators, the 1923 to 1929 period was a prosperous era for Canadians. Exports expanded by one-third, real income grew by 25 per cent, and immigration during the decade exceeded one million.[166] Sectors experiencing the most rapid growth were wheat and pulp and paper buoyed by rising commodity prices. Fixed capital formation and provincial public works also expanded rapidly being closely associated with hydro-electric developments and road building.[167]

Economists frequently remind us that Canada is a "small, open economy", a nation which is heavily dependent on world trade for its economic well-being. Therefore, it is necessary to examine the imbalances underlying the international economy leading to the Great Depression.

The International Context

The Great War left the United States in the position of the world's creditor. According to one analyst, there were three basic reasons why America's new-found hegemony tended to destabilize the world's financial system. Firstly, the operation of the gold standard was most successful when London was the unchallenged centre of international finance. After the War, with both Paris and New York competing as world financial centres, the probability of complications arising multiplied. Second, New York was "inexperienced" as a world trade centre and this weakness was magnified by its lack of dependence on foreign trade. Unlike England, which would immediately suffer from a drying up of world trade and credit, American financiers and legislators tended to see more benefits flowing from a policy of autarchy than dangers inherent in trade

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166 W.A. Mackintosh, *The Economic Background to Dominion-Provincial Relations*, A Study prepared for the Royal Commission on Dominion Provincial Relations, (Ottawa: 1939), Table 15, p. 41.

167 See A.E. Safarian, *The Canadian Economy in the Great Depression*, (Toronto: 1957), pp. 21–35.

protectionism. In other words, the conflict between domestic and foreign economic policy was sufficient to produce Smoot-Hawley and other tariff barriers; measures which would have been suicidal to England's economy. And third, the New York capital market was largely a money market. Therefore, it was capable of disbursing only *short-term* credit to debtor countries when long-term assistance was required.[168] Compounding these problems of international financial realignment was the hornet's nest of reparations payments. French insistence on seeking damages and American demands for repayment in full lent an unreal air to negotiations in this period. And as mentioned, aggravating the world's financial difficulties were America's protectionist policies, policies that made repayment of interest and principal far more difficult for the debtor nations.[169]

The New York money market played a crucial role in the years immediately preceding the Crash when vast sums poured in from abroad to speculate on a rising New York Stock Exchange "bull market". As stock prices escalated more money was demanded by intoxicated investors and loaned through the short-term, "call loan" market.[170] During 1929, the call loan rate peaked at 20 per cent on March 26th and remained between 10 and 15 per cent during the summer of 1929. Despite these rates, The Bank of Nova Scotia commented "the demand for funds at call was insistent, and it seemed as though the market could not secure enough at that figure."[171] Yet one year after this speculative binge, call loan rates stood at two per cent and money could not be given away even to credit-worthy borrowers. During the boom, some Canadian bankers, to their credit, cautioned against speculative excesses, including Sir John Aird of the Canadian Bank of Commerce. Sir John, speaking before the Bank's 1928 Annual Shareholders meeting, noted:

In view of the widespread prevalence of speculation it is well to remember that

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[168]William Adams Brown Jr. analysis is recounted by F.A. Knox in "Review Article: The International Gold Standard Reinterpreted," *Canadian Journal of Economics and Political Science*, Volume 10, No. 4 (November 1944), pp. 503-507. See also E.L. Hargreaves who also argued that one of the problems underlying the financial crises of the 1920s and early 1930s was the absence of any legal authority to enforce payment. "Debt" in G.D.H. Cole (ed.), 1936, p. 437. The parallels with to-day's short-term bank lending to Latin America are quite striking.

[169]Mackintosh, 1939, p. 55.

[170] A "call loan" is a loan which may be liquidated or called by the lender on notice, payable by the borrower for settlement on the next banking day. Idle funds of Canadian banks were usually placed "on call" in this manner prior to the creation of the Bank of Canada. Thereafter, Canadian treasury bills became the banks' second line cash reserves.

[171]The Bank of Nova Scotia, "Ten Percent and Two Percent," *Monthly Review*, Toronto, August, 1930.

> a rise in prices in the stock markets does not in itself increase the wealth of a country. In so far as it is due to inflation of credit it amounts to a revaluation on paper mainly made in anticipation of what the future may bring. If these anticipations are realized all goes well, but, too often, the reverse is the case. The supply of credit from the banks should be based, not on mere anticipations of future wealth, but on that which is actually in existence, and which can be utilized for the increase of bank reserves. On this basis alone can a sound expansion of bank credit take place.[172]

During the boom, however, Canadian banks borrowed extensively under the *Finance Act* at 3.5 to 5 per cent placing large sums at call in New York. Professor Curtis calculated that advances peaked in November 1929 at $111 million, declining thereafter to $21 million in August 1930.[173] Bankers, however, were quick to deny that the drying up of credit was related to, or caused, the falling off of prices which commenced with a venegence in 1930.[174] By March 1930, wholesale prices had fallen to levels last observed in 1916, prompting many investors and agriculturalists to ponder if prices could go much lower. Prices did continue to drift downwards and by the first quarter of 1933 reached their lowest point sine pre-war days.

Onset of Depression

During the wave of credit contraction which spread through the nation between 1930 and 1935, banks liquidated industrial and farm loans purchasing government bonds instead. As noted below, the conservatism of bankers supposedly preserved the integrity of Canada's financial system and emphasized time and time again by bourgeois politicians and financiers alike. Still, this very conservatism was responsible for driving many farmers and businesses to the wall. According to Professor McIvor, bankers were incapable, and perhaps unwilling, to recognize the interrelation between individual bank action and the operations of the banking system on the economy as a whole.

> The point at which the banks may be criticized is not that they were wrong in keeping safe and sound, or even that in the process of doing so they effected a highly undesirable contraction of the country's means of payment. The ultimate responsibility for this contraction must rest not with the banks but with the government which failed to assume any responsibility for control of the total means of payment in the economy. The basic criticism of the bankers is

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[172]Canadian Bank of Commerce, *Annual Report, 1928*, p. 38. See also comments of Mr. Peleg Howland, General Manager, Imperial bank of Canada, *Annual Report, 1929*, p. 16 and testimony of Mr. Jackson Dodds, General Manager, Bank of Montreal to the House of Commons Standing Committee on Banking and Commerce, 17th Parliament, 5th Session, Tuesday, 27 March 1934, pp. 216–220.

[173]Cited in *Proceedings*, Royal Commission on Banking and Currency, p. 3173.

[174]For instance S.H. Logan, General Manager of the Canadian Bank of Commerce, who reminded his shareholders that commodity prices had been declining prior to the reduction of bank credits.*Annual Report, 1932,* p. 20.

> rather that they neither understood nor were willing to learn the economic consequences of their own actions, and they consequently provided a great deal of ill-informed opposition to the subsequent formation of a central bank. It should of course be emphasized that the failure to recognize the connection between monetary contraction and the aggravation of the Canadian depression was no means confined to the bankers. It was almost universal in those early days.[175]

It may be noted in passing that the stock market collapse and the onset of depression were widely discounted by business leaders and the financial press during 1930 and 1931. There were many declarations praising the soundness of the economic system and statements to the effect that the downswing was only temporary and recovery was just around the corner. Perhaps the 'coup de grace' was provided in September 1931 when Britain's decision to abandon gold threw currency and capital markets into disarray.[176]

The collapse of commodity prices brought into question the large debts owed by staple exporting nations, Australia, Latin America, and Canada. In 1931, Australia reduced all interest payments on internal public debts and some private debts by 20 per cent. In May 1931, the giant Austrian bank, *Kreditanstalt* collapsed sending a wave of panic north through central Europe. Increasingly, pressure was placed on the United Kingdom as many institutions were vitally concerned with England's loans to Germany. This led to a heavy redemption of gold against the United Kingdom's reserves during the summer of 1931 and eventually to the decision on 21 September to abandon the gold standard.[177] As one investment dealer told the author, "this led to a distrust of everything."[178] Canadian bond prices fell three and four points during the next few days as did the dollar in New York which reached a low in December 1931 of 80.36 cents in U.S. funds. As deflation accompanied a devaluation of currencies against the U.S. dollar, many debtor countries had very little choice except to default to, primarily, their American bondholders. In March 1931, Peru suspended payments, extending its moratorium the following January. In January 1932, Mexico formally revoked its previous undertakings of July 1930 and July 1931 to maintain a new schedule of debt repayments. Similar scenarios were re-enacted

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[175] McIvor, 1961, p. 130. Also Brecher, 1957, p. 33.
[176] In Montreal, three brokerage houses were forced to close their doors in the wake of the unsettled market conditions which brought rising short and long-term rates. See A.B. Jamieson, *Chartered Banking in Canada*, (Toronto: 1953), pp. 76-77.
[177] See W.C. Clark, "The Flight from the Gold Standard," *Queen's Quarterly*, Volume 38, No. 4,(Fall 1931), pp. 751-755.
[178] *Interview*, 26 May 1982.

in Portugal, Greece, Turkey, and Bulgaria.

The early years of depression were characterized by deflationary pressures which in turn led to grave doubts about the collectibility of debts, both public and private, contracted during the previous boom. Furthermore, heavy losses occasioned on the stock market by American banks did much damage to America's unit banking system and to undermine ordinary Americans' faith in the equity markets. The main problem remained a heavy burden of indebtedness relative to depressed price levels. The paralysis of the world's economic system was exacerbated also by a steep reduction in the quantum of world trade which decreased by slightly over one-quarter between 1929 and 1933.

Statistical Evidence 1928-1939

Real income in Canada which grew by approximately 25 per cent during the twenties, fell by almost 30 per cent from its peak in 1929 to the nadir of 1933. Particularly hard hit were the staple exporting prairie provinces whose income in constant dollars fell by one-half. Table 3.1 shows that government expenditure patterns were consistent with economic developments, though a lag is observed from 1930 to 1931. Fixed capital formation by business fell off a dramatic 80 per cent by 1933. A.E. Safarian's analysis suggests that the large capital development projects undertaken throughout the 1920s produced a modern, highly capital intensive, industrial structure and exhausted the list of economically viable capital projects. Over-expansion in the pulp and paper, railways, and hydro-electric sectors meant new projects would be superfluous.[179] However, the accompanying reduction in government and crown corporation capital investment seriously aggravated this sector.[180] Between 1929 and 1934, governments' capital formation expenditures dropped from $190 million to $10 million. The Governments' fiscal policy was decidedly pro-cyclical over the period, being geared to retrenchment during depression and to competition with private industry for funds during the boom years.[181]

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[179]Safarian, 1957, p.42.

[180]Stewart Bates, *Financial History of Canadian Governments*, A Study prepared for the Royal Commission on Dominion Provincial Relations, (Ottawa: 1939), pp. 72-79.

[181] An American study by E. Carey Brown showed that fiscal stimulus in the United States did not work because it was not tried. While expansion was fairly strong during 1934-1936, tax increases in part, were responsible for stalling recovery in 1937. "Fiscal Policy in the Thirties," *American Economic Review*, Volume 46, No. 4 (December 1956), pp. 865-867.

Not surprisingly, personal consumption did not fall as dramatically as capital formation expenditures– much of the decline reflecting falling wholesale and retail prices on domestic and foreign goods and services.

TABLE 3.1

National Income 1928-1939

YEAR	Govt. Expend.* (1)	Fixed Capital Formation (2)	Personal Consumption (3)	Net National Income Factor Cost (4)	GNP Market Prices (5)
1928	560	1007	4,314	4,737	6,046
1929	640	1161	4,621	4,708	6,134
1930	721	926	4,367	4,399	5,728
1931	688	622	3,773	3,382	4,699
1932	584	319	3,194	2,641	3,827
1933	462	234	2,984	2,368	3,510
1934	503	298	3,182	2,783	3,984
1935	542	369	3,338	3,099	4,315
1936	544	458	3,549	3,367	4,653
1937	619	633	3,884	3,887	5,257
1938	666	592	3,897	4,001	5,278
1939	683	592	3,984	4,236	5,636

(In $ millions Canadian)

SOURCES: Dominion Bureau of Statistics, *National Accounts- Income and Expenditure, 1926-1956,* Columns 1–3, Table 2, Columns 4, 5, Table 1.
**Excludes* transfers and subsidies to other governments.

Table 3.2 illustrates the great volitility of corporation profits during the decade. After heavy losses in 1932, the trend shows a decided improvement in the years 1933 through to 1937. Profit shares highlight the cyclical nature of Canadian capitalism. As the table indicates, wages and salaries too were affected by the business cycle although inversely to corporation profits. The data seems to suggests that the hardship of the depression was mainly experienced by those without employment, whose numbers peaked at approximately one–quarter of the work force in 1933 and the independent commodity producers.

TABLE 3.2

Distribution of National Income, 1928-1939

YEAR	Wages, Salaries	Corp. Profits before Tax	Rental, Interest, Misc Income	Agric. Income	Non-Agricultural Businesses
	(1)	(2)	(3)	(4)	(5)
1928	57.3	9.2	7.6	13.4	12.4
1929	62.5	8.4	7.8	8.3	13.1
1930	63.3	3.3	7.7	7.8	12.3
1931	71.2	0.4	8.0	2.8	12.1
1932	74.8	−3.7	8.5	3.9	11.9
1933	75.5	3.1	7.3	2.8	11.3
1934	69.7	6.9	7.2	6.0	11.5
1935	67.1	7.6	7.1	7.0	11.8
1936	66.6	9.3	7.2	5.9	11.4
1937	65.3	11.1	7.0	7.2	11.5
1938	62.9	8.4	6.5	8.8	11.2
1939	61.4	12.3	7.1	8.5	10.5

SOURCES: Dominion Bureau of Statistics, *National Accounts- Income and Expenditure, 1926-1956*, pp. 26–27.

The beneficiaries of deflation, besides those with job tenure, were individuals receiving income under fixed contracts who increased their share of income in the early years of the decade.[182] Non–agricultural business income, in contrast to agricultural incomes, remained remarkably constant throughout the decade. Export prices fell more rapidly than did import costs to 1932 reflecting the relatively more resistant price level of processed imports from the United States and elsewhere. While domestic prices had shown a substantial recovery to pre–depression levels by 1939, this was certainly not the case for commodities traded between nations. Indeed, in 1939, there were fears that the moderate reflation occurring between 1934 and 1938 had been arrested and deflationary pressures were returning to the market.

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[182]Some analysts, including D.C. MacGregor, calculated that the share of national income going to the payment of debts actually doubled in the early years of the Depression. Because Column (3) includes a variety of income including rent, the assertion is quite probable.

TABLE 3.3

Gross National Expenditure, Implicit Price Indices

(1949=100)

YEAR	Personal Consumptn. (1)	Govt Expend. (2)	Fixed Capital Formation (3)	Imports (4)	Exports (5)
1928	70.4	61.7	58.0	63.7	64.1
1929	71.2	62.3	59.6	62.9	62.7
1930	70.4	61.2	57.6	57.8	56.8
1931	64.2	59.3	54.4	50.8	47.5
1932	59.0	56.1	52.4	46.8	42.7
1933	56.6	54.9	50.7	45.4	43.4
1934	57.5	54.9	51.4	48.8	47.3
1935	57.8	55.8	52.1	49.0	48.3
1936	58.8	56.6	52.9	50.3	50.2
1937	60.5	58.6	56.9	54.2	54.8
1938	61.5	59.1	56.4	51.6	51.7
1939	61.2	59.1	56.2	51.1	50.3

SOURCES: Dominion Bureau of Statistics, *National Accounts- Income and Expenditure, 1926-1956*, Table 6.

This impression is supported by examining the data in Table 3.4. While unemployment declined to well below the peak levels reached in 1933, by 1938 it was apparent that the recovery might be aborted as the numbers of the unemployed grew by 25 per cent. K.W,. Taylor estimated that on the eve of World War II, there were 600,000 Canadians out of work which would have translated into an unemployment rate of about 13 per cent.[183] Unemployment was a chronic problem throughout the decade depriving many Canadians of adequate housing and nutrition and acting to dampen the consumption required to adequately sustain an economic recovery.

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[183] "Canadian War-Time Price Controls, 1941-1946," *Canadian Journal of Economics and Political Science*, Volume 13, No. 1 (February 1947), p. 81.

TABLE 3.4

Employment 1931-1939

YEAR	Non-Agric. Employment (1)	Agric. Employment (2)	Total Employment (3)	Unemployed (4)	Unemployment Rate (5)
1931	2,427	1,203	3,630	475	11.6
1932	2,209	1,223	3,432	733	17.6
1933	2,168	1,243	3,411	817	19.3
1934	2,403	1,263	3,666	624	14.5
1935	2,452	1,284	3,736	618	14.1
1936	2,548	1,304	3,852	565	12.8
1937	2,746	1,324	4,070	406	9.1
1938	2,678	1,334	4,022	516	11.4
1939	2,711	1,364	4,075	523	11.4

(Figures in thousands of workers)
SOURCES: Dominion Bureau of Statistics, *Canada Year Book*, 1954.

Canada's external trade position "improved" in the sense of moving from a deficit position on current account to a surplus position at the depths of the depression. Canada's movement towards a surplus was influenced in part by tariffs raised by Bennett in late 1930 which added to a sharp fall off of imports. Imports fell by an astonishing 50 per cent between 1929 and 1932 as did current receipts or exports. The financing of the pre-depression and early depression year deficits was mainly accomplished by substantial capital imports in 1930.[184] After 1930, capital imports fell sharply as did the Canadian dollar *vis-a-vis* the U.S. dollar after September 1931. Canada followed the pattern of other debtor countries during the decade by reducing her balance of international indebtedness.[185] In broader terms, world trade contracted dramatically and this harmed the export producing regions, notably Western Canada. Table 3.5 shows a drop in Canada's exports of 50 per cent at the bottom of the cycle; much of this drop reflected the drought in the West and falling prices for grains. Recovery of trade and prices was so slow that by 1939, total dollar exports remained nearly 20 per cent below the level of 1929.

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[184]F.A. Knox, *Dominion Monetary Policy, 1929-1934*, A Study prepared for the Royal Commission on Dominion Provincial Relations, (Ottawa: 1939), pp. 8-10.
[185]Bloomfield, 1940, p. 506.

TABLE 3.5

Canadian Balance of Payments, 1928-1939

YEAR	Current Account (1)	Current Receipts (2)	Current Expenditures (3)	Net New Issues (Retirements) (4)
1928	−32	1,788	1,820	+7
1929	−311	1,646	1,957	+147
1930	−337	1,297	1,634	+290
1931	−174	972	1,146	−12
1932	− 96	808	904	− 1
1933	− 2	829	831	−32
1934	+ 68	1,020	952	−58
1935	+125	1,145	1,020	−139
1936	+244	1,430	1,186	−164
1937	+180	1,593	1,413	− 80
1938	+100	1,361	1,261	− 62
1939	+126	1,457	1,331	− 96

(in $millions Canadian)

SOURCES: Columns (1)–(3) Dominion Bureau of Statistics, *Canada Year Book*, 1954 and Column (4), Bank of Canada, *Statistical Supplement, 1946*.

Dominion finances exhibited wide fluctuations in the revenue accounts causing unpredictable variations in the deficit. Though expenditures consistently rose throughout this period, revenues plummeted as national income dropped *in spite of tariff and tax increases.* The unanticipated revenue shortfall led to large deficits, notably those experienced between 1930 and 1935. Thereafter, a gradual "economic recovery" ameliorated the Government's cash requirements. Considering the Dominion's sizeable deficits, the modest rise in fixed interest charges was a major achievment which was aided by a secular decline in international interest rates after 1932 and the lack of sound borrowers which encouraged banks to invest in Dominion debentures.

TABLE 3.6

Dominion Government Finance, 1928-1939

YEAR	Total Current Expend.* (1)	Total Current Revenues (2)	Surplus / Deficit (3)	Interest Charges (4)	Surplus Deficit % of Total Expend. (5)	Interest % of Total Expend. (6)
1928	295	429	+105	125	+35.6	42.4
1929	306	396	+56	122	+18.3	39.9
1930	313	271	÷96	121	−30.7	38.6
1931	352	227	−160	121	−45.5	34.4
1932	353	211	−154	135	−43.6	38.2
1933	355	245	−114	140	−32.1	39.4
1934	381	294	− 93	139	−24.4	36.5
1935	420	310	−121	134	−28.8	31.9
1936	434	399	− 37	137	− 8.5	31.6
1937	448	460	+ 9	137	+ 2.0	30.6
1938	485	411	−87	129	−17.9	26.6
1939	448	455	− 2	134	− 0.4	29.9
1928−39	+52%	+6%	−	+7%		

(in $millions Canadian)

SOURCES:− Column (l) CANSIM Mini−series identifier D 30592, Column (2) D 30555, (3)D 30610, (4) D 30581.

* *Excludes* transfers to other governments.

From 1928 to 1939, provincial expenditures rose twice as rapidly as Dominion expenditures, much of it due to relief costs, while revenues over the decade grew by 90 per cent as opposed to a 6 per cent growth in Dominion revenues. The Dominion's credit standing therefore was very fragile during the early years of the depression which prompted the Government to hold back on certain information emanating from the Bureau of Statistics (see Chapter VIII below). According to Professor MacGregor:

> The credit of the Federal Government has been sustained chiefly by the fact that it is the sovereign authority, possessing unlimited taxing powers and a reservoir of credit under the Finance Act. But for all practical purposes these exclusive privileges of the Federal Government do its position more harm than good. *They enable it to add to its responsibilities without limit, but they have not thus far been used to help to carry the added weight of the resulting debt.*[186]

The Dominion was, however, fairly successful in controlling its interest charges relative to the provinces in spite of a $1.1 billion rise in the outstanding debt. This savings occurred after 1936, when the bulk of the war loans at five per cent had been retired.

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[186]"These Insignificant Budgets," *The Canadian Forum*, Volume 14, No. 166 (July 1934), p. 387.

During the period 1930 to 1934, the provinces were seriously exposed to the negative effects of fluctuating exchange rates which in the case of Alberta added nearly one million dollars per annum to their borrowing costs. Nevertheless, aggregate charges on the public debt amounted to only one-half of those faced by Ottawa and the table also reveals that the provinces were more careful than the Dominion in matching their expenditures with their income. Interest charges as a portion of total expenditures were consistently lower for the provinces as a whole. Unfortunately Table 3.7 masks the great diversity in the respective financial positions of the provinces which varied between the near-bankrupt western provinces and the more financially viable Government of Quebec. In Alberta, debt charges consumed nearly 35 per cent of the provincial budget, while Saskatchewan spent 29 per cent on debt charges. This compares to 10 per cent in Quebec in 1935.[187] Another factor explaining the provinces' somewhat superior financial health was their attitude to municipal defaults. Instead of bailing local governments out by advancing funds to prevent default, the governments allowed their municipalities to default as a means of forcing creditors to renegotiate the terms of the outstanding debts.[188]

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[187]Royal Commission on Dominion-Provincial Relations, Public Accounts Inquiry, *Province of Alberta Comparative Statistics on Public Finance, 1913,1921, 1926-1937*, Appendix J, *Province of Quebec Comparative Statistics on Public Finance*, Appendix E, and *Province of Saskatchewan, Comparative Statistics on Public Finance*, Appendix H. (Ottawa: 1939).

[188]Examples include the cities of Windsor, Vancouver, Calgary, and Montreal. See also Bradshaw, 1935.

TABLE 3.7

Provincial Government Finance, 1928-1939

YEAR	Total Current Expend*	Total Current Revenues	Surplus Deficit (1)-(2)	Interest Charges	Surplus Deficit % of Total Expend.	Interest % of Total Expend.
	(1)	(2)	(3)	(4)	(5)	(6)
1928	181	195	+ 14	43	+ 7.7	23.8
1929	203	220	+17	47	+ 8.3	23.2
1930	232	232	0	51	--	22.0
1931	282	241	- 41	57	-14.5	20.2
1932	288	236	- 52	64	-18.1	22.2
1933	278	228	- 50	69	-18.0	24.8
1934	331	251	- 80	72	-24.2	21.7
1935	334	295	- 39	75	-11.7	22.5
1936	340	349	+ 9	71	+ 2.6	20.9
1937	361	388	+ 17	69	+ 4.8	19.1
1938	401	375	-26	71	-6.5	17.7
1939	394	372	-22	75	- 5.6	19.0
1928-39	+118%	+91%	-	+74.4%		

(in $millions Canadian)

SOURCES:- Column (l) CANSIM Mini-series identifier D 30592, Column (2) D 30555, Column (4) D 30581.

* *Excludes* transfers to other governments.

Chart 3.1 traces the course of interest rates during this period of great turbulence. Several points may be emphasized. Firstly, the highly unusual relationship between long-term and short-term security yields. The reversal of the "normal" relationship between 1929 and early 1932 is evidence of the great uncertainty which gripped securities markets at this time.[189] Secondly, the chart illustrates a secular decline in interest rates beginning in the first quarter of 1932 and succeeding several years of wildly fluctuating market activity. This decline was prompted by the successful conversion loan in the United Kingdom during the summer of 1932. This development was particularly helpful in aiding the Canadian and other governments in the financing of their large deficits.[190]

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[189]This phemonenon also occurred during the last quarter of 1979 and throughout 1980 and 1981 when short-term yields peaked at 21 per cent and long-term bonds were trading to yield 17 per cent.

[190] J.T. Bryden, 1937, p. 436. Of course the nominal rate of interest only tells part of the story. In a long-term study done on American investment returns, Roger Ibbotson and Rex Sinquefield show that shortly after 1930 the real rate of return on long-term government bonds jumped to nearly 10 per cent during the early deflationary period and remained in the three to seven per cent range during the thirties. *Stocks, Bonds, Bills, and Inflation: Historical Returns (1926-1978)*, (New York: 1979), Exhibit 2, p. 5. Given Canada's

Thirdly, a widening of the interest differential between long and short-term yields which commenced in early 1934 must be noted. According to the investment dealer, Stanley Nixon, this movement encouraged the Dominion to resort to larger issues of treasury bills.[191] The low rates tended to be seen by government officials as a *sine qua non* for staving off insolvency in much the same vein as international bankers now view the necessity for lower interest rates. Lower rates were regarded in the financial community however with some suspicion as possibly encouraging governments to embark on a programme of extending services beyond the bounds that was believed prudent.[192] Moreover, in some quarters, low rates were seen as tantamount to governments "confiscating" the savings of small depositors.[193] Doubts were also raised by salaried trustees over the appropriateness of a cheap money policy as a remedy for the depression.[194]

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[190](cont'd)experience with deflation and the traditional interest rate differential with the United States (normally between .50 per cent and 1.00 per cent on long-term funds during the period), it is probable that the real rate of return to holders of government debt was above eight per cent throughout most of the decade.

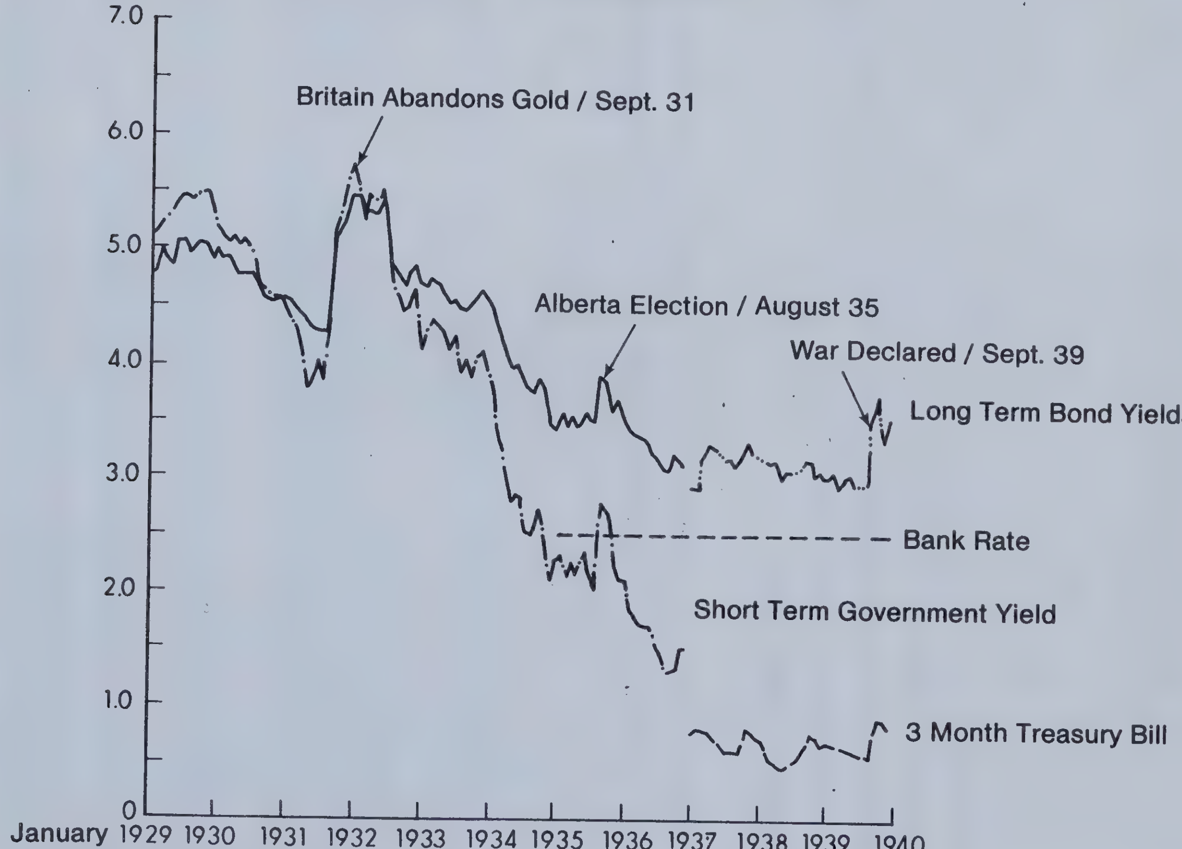
[191]"The Course of Interest Rates," *Canadian Journal of Economics and Political Science*, Volume 3, No. 3, (August 1937), pp. 428-429. Of course, another reason for the sale of treasury bills was to establish the basis for open market operations to be undertaken by the central bank when it began operations in March 1935. In other words, the first issue of treasury bills since World War I was not entirely premised on the desire for a cheap source of funds.

[192]Bryden, 1937, pp. 438-439 and Walters, 1939, pp. 340-344.

[193]Statement of Sir Charles Gordon, President, Bank of Montreal, *Annual Report, 1935*, p. 6.

[194]A.E. Phipps, General Manager, Imperial Bank of Canada, *Annual Report, 1935,* p. 25 and S.H. Logan, President, Canadian Bank of Commerce, *Annual Report, 1938,* p. 20. "I think that most people recognize that easier money will not cure our existing problems. Certainly substantial reductions in the interest rate on bank loans have not brought about any marked increase in borrowings."

Figure 3.1 Government of Canada Bond Yields



Sources: 1929–37, S.E. Nixon, "Interest Rates in Canada", CJEPS, Volume 3, No. 3., (August 1937) Tables *II*, *VI* pp. 424, 427, 1937–39 Cansim Mini-Series Identifiers Bank Rate B 14006, Long-term Bonds B 14013, Treasury Bills 14007.

Our review of this period may be summarized as follows:

1. Between 1928 and 1933, Canada suffered a drop in real income of unprecedented magnitude. A slow, uncertain recovery followed but towards the end of the decade prices again began to slip downwards and unemployment and trade began a downward slide.

2. The effects of this catastrophic fall in national income were felt most severely in the staple exporting regions, the three prairie provinces and in the pulp and paper towns of Ontario, British Columbia and Quebec.

3. Government economic intervention was pro-cyclical exacerbating the dislocations and distortions associated with economic booms and slumps.

4. Borrowing from abroad was seriously curtailed with retirements exceeding new issues placed abroad. The nation moved from a deficit position to surplus position on current account.

5. Dominion Government finance was especially vulnerable in the early years of the Depression handicapped by railway deficits[195] and a sharp fall in revenues from the tariff. Collectively, provincial governments were in a more enviable position although the drain of relief costs and the drastic decline of income in the western provinces forced the Dominion to advance over one hundred million dollars to these provinces during the 1930s.

6. Falling interest rates after 1931 played a significant role in controlling the drain of fixed interest charges from public treasuries. This secular decline was consistent with the trend in other western nations.[196]

In the context of debt management, unanticipated, massive deficits and the decline of long-term and short-term interest rates were the main factors influencing decision-making. As will be discussed in Chapter V, the heavy maturities scheduled for redemption in 1934-1937 made the arrival of lower interest rates particularly welcome.

The Economy in War-Time

"Indeed, the crucial problem of war finance," wrote Benjamin Higgins, "is to dislodge money from its customary channels and guide it into the public treasury, in a manner that provides enough income incentive to shift resources and nevertheless avoids undue hardship for any group."[197] Initially, the challenge which faced Canadian officials was to increase the national income, to bring the country towards full employment, and to encourage investment without immediately raising taxes so high as to retard the growth in

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[195]During the 1930s the Canadian National's deficits ranged between $40 and $61 million leading to a very heavy drain on the public purse and demands from interested parties that the railway be sold to save taxpayers' moneys. *Canada Year Book*, 1940, p. 648.
[196]See R.B. Bryce, "The Effects on Canada of Industrial Fluctuations in the United States," *Canadian Journal of Economics and Political Science*, Volume 5, No. 3 (August 1939), p. 383 on the interdependence of the Canadian and U.S. securities markets.
[197] *Canada's Financial System in War*, (New York: April 1944), p. 1.

national income. Hence, resort was made to bank financing in the autumn of 1939 for (1) "its expansive effect", (2) the uncertainty of a successful public offering at this early date, and (3) as a stopgap to allow the market to adjust to new conditions.[198]

It is evident from public statements and private correspondence that the Dominion was pledged to financing the war at a reasonable cost and was determined to avoid the inflation which took hold towards the end of the Great War. To avoid a recurrence of inflation, it was the original intent of the Government to finance the war through taxation as opposed to borrowing. Central to this strategy was a policy aimed at reducing private consumption. According to Governor Graham Towers:

> This is the all important factor–*abstention from consumption*. If a person does that but does not subscribe to a War Loan his action is nevertheless useful. But if a person subscribes from past savings in the bank, but does not keep his consumption as low as it should be, he has not really benefitted the country.[199]

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[198]W.C. Clark to J.L. Ilsley, 5 September 1939, *Public Archives of Canada*, RG 19, Volume 3427 and W.C. Clark to J.L. Ilsley, 12 October 1939, *Public Archives of Canada*, RG 19, Volume 3978, File F–1–11.

[199]Towers Memoranda, No. 371, 24 December 1940, "General Considerations Relating to War Savings Publicity– Methods and Objectives," p. 2, *Bank of Canada Archives*.

TABLE 3.8

National Income 1928-1939

YEAR	Govt. Expend.* (1)	Fixed Capital Formation (2)	Personal Consumption (3)	Net National Income Factor Cost (4)	GNP Market Prices (5)
1940	1,116	803	4,488	5,063	6,743
1941	1,635	1,085	5,103	6,305	8,328
1942	3,674	1,064	5,500	8,098	10,237
1943	4,177	887	5,808	8,802	11,088
1944	4,978	900	6,274	9,583	11,850
1945	3,656	1,031	6,969	9,665	11,835
1940-45	228%	28%	55%	91%	76%

(In $ millions Canadian)

SOURCES: Dominion Bureau of Statistics, *National Accounts- Income and Expenditure, 1926-1956,* Columns 1-3, Table 2, Columns 4, 5- Table 1.
* *Excludes* transfers and subsidies to other governments and war expenditures other than by Departments of Defence and Defence Production.

An examination of Table 3.8 in conjunction with Table 3.10 indicates that the Government's capacity to limit the flow of money income into personal consumption on goods and services was a limited success. Although the price level for personal consumption rose "only" 18 per cent during the war, total personal consumption rose by 55 per cent indicating that government measures, including rationing certain goods, had a limited effect.[200]

All sectors of the economy grew dramatically, most notably the government sector which, by 1943-44, accounted for nearly one-half of the national income which contrasts with approximately 10 per cent during the First World War.[201] Table 3.9 shows that by 1942, the share of national income controlled by the agricultural sector had been almost restored to its pre-depression level and profits grew at the expense of the wage-earning population. The proper balance between providing incentives for business and taxing away excess, war profits was a thorny problem for the Government. An "excess profits tax" was introduced in the September 1939 budget and was immediately criticized because it would not be effective until 1940 and the legislation allowed for

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[200]Higgins, 1944, p. 79.
[201] This is strictly government expenditures. If one adds munitions exports, the total figure would approach about one-third of national income devoted to war-related activity in 1914-18.

liberal tax allowances on capital investment.[202] Deputy Finance Minister Clark in an internal memo addressing some of the political implications of war taxation, stated:

> Profit incentive must be maintained and there must be special rewards to induce business efficiency and enterprise, but at the same time the Canadian public will probably not stand for the profit levels by businessmen which cannot be justified in comparison with the human sacrifices that will have to be asked from individuals.[203]

This decidedly pro-business stance of Clark's contrasted markedly with the position taken by his subordinate policy-advisor, R.B. Bryce.. As profits continued to increase through into 1942, the Government developed a more elaborate scheme to increase the excess profits tax only to return 20 per cent of the tax collected after the war. Bryce doubted the long-term wisdom of this course, observing:

> However, the proposal is open to the very serious objection that we are proposing to continue after the war the same domination of industry by big monopolistic corporations that plagued us before the war. It may be argued with some justice that the people who will gain the most from these provisions will be firms like International Nickel, Consolidated Smelters, The Aluminum Company, General Electric, the automobile companies and others who are well established and making very large profits. The 20% returned to them on the condition that they must re-invest it, *will help further to establish them in the Canadian industrial picture and enable them to consolidate their gains and achieve even more dominance than before the war.*[204]

This measure did contribute to a reduction of corporate profits as a portion of the rising national income. Still, the vast improvement in corporate profits offers an interesting contrast to the declines suffered by wage labourers relative to the depression era when wage levels were high in the presence of a large army of unemployed workers.

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[202] *The Canadian Forum*, "Who Pays?" Volume 19, No. 225 (October 1939), pp. 204-205.
[203] W.C. Clark to J.L. Ilsley, 5 September 1939, p. 5, *Public Archives of Canada*, RG 19, Volume 3477.
[204] "Memorandum re. Refund Conditions on 20 % Fraction of Excess Profits Tax," p. 2, *Public Archives of Canada*, RG 19, Volume 3551, File B-04C. (emphasis added)

TABLE 3.9

Distribution of National Income, 1940-1945

YEAR	Wages, Salaries	Corp. Profits before Tax	Rental, Interest, Misc Income	Agric. Income	Non-Agricultural Businesses
	(1)	(2)	(3)	(4)	(5)
1940	58.5	13.2	6.9	9.5	10.5
1941	57.2	15.1	6.6	7.4	10.1
1942	52.9	14.0	6.6	11.5	8.6
1943	54.7	12.8	6.5	8.2	8.5
1944	52.1	11.3	6.1	11.4	8.5
1945	52.1	11.4	6.4	9.4	9.4

SOURCES: Dominion Bureau of Statistics, *National Accounts- Income and Expenditure, 1926-1956*, pp. 26–27.

Between March and September 1941, prices rose steadily at nearly twice the rate experienced in the preceding 15 months of war. One explanation for this phenomenon was offered by Professor Parkinson of the University of Toronto.

> When the economy *begins to approach a condition of full employment*, therefore, the combined effect of increased exports and increased government expenditures financed by bank credit will have inflationary consequences unless a large proportion of the induced increase in private incomes is simultaneously drained away to the Treasury by taxing and borrowing.[205]

Parkinson's general point was that as the economy heated up, "additions to the total expenditures are more likely to multiply prices than to multiply production."[206] During the summer and fall of 1941, pressure mounted on Prime Minister Mackenzie King to approve a price control scheme which was finally announced on 18 October 1941. The programme called for a universal price ceiling and a variety of subsidies on such necessities as basic foodstuffs and coal. In November, a wage ceiling was introduced along with a cost of living bonus plan. Bonuses were paid in July 1942 and November 1943.[207] As Table 3.10 illustrates, the Wartime Prices and Trade Board was successful in keeping prices for consumer goods in check from 1942 to 1945. The universal scheme was adopted for reasons of "promptness, in applying an effective remedy, equity, administrative manageability, and political acceptability."[208]

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[205]Parkinson, 1940, pp. 407–408. (emphasis added)
[206]*Ibid*, p. 406.
[207]Higgins, pp. 14–18.
[208]Taylor, 1947, p. 87. Certain products including fresh fruit and vegetables were

Import prices were regulated via an import subsidy programme for essential goods.[209]

TABLE 3.10

Gross National Expenditure, Implicit Price Indices

(1949=100)

YEAR	Personal Consumptn. (1)	Govt Expend. (2)	Fixed Capital Formation (3)	Imports (4)	Exports (5)
1939	61.2	59.1	56.2	51.1	50.3
1940	63.8	62.2	59.8	56.4	55.1
1941	68.3	64.6	64.5	59.7	57.4
1942	71.5	70.8	67.9	65.0	61.3
1943	73.5	73.1	71.9	68.7	64.5
1944	74.3	76.6	72.9	71.1	68.9
1945	75.2	80.5	72.6	73.0	71.1
1940-45	18%	29%	21%	29%	29%

SOURCES: Dominion Bureau of Statistics, *National Accounts- Income and Expenditure, 1926-1956*, Table 6.

As is to be expected during war-time, unemployment was practically neglible when the war effort peaked in 1944. Under the National Service Regulations made effective on 1 September 1942, persons' freedom to leave their place of employment was effectively terminated and National Service Selection officers were empowered to order partially employed individuals into full-time labour. The data on Table 3.11 shows a rapid rise in non-agricultural employment during the first three years of war (approximately 550,000). Corresponding to this rise was a rapid fall in agricultural employment, a fall of nearly 200,000 or nearly one-sixth of the agricultural work force.

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[208](cont'd)exempted from the ceiling due to seasonal variations.
[209]*Ibid*, p. 87.

TABLE 3.11

Employment 1940-1945

YEAR	Non-Agric. Employment (1)	Agricult. Employment (2)	Total Employment (3)	Unemployed (4)	Unemployment Rate (5)
1940	2,809	1,329	4,138	418	9.2
1941	3,014	1,210	4,224	193	4.4
1942	3,258	1,127	4,385	134	3.0
1943	3,340	1,107	4,447	75	1.7
1944	3,319	1,126	4,445	62	1.4
1945	3,277	1,134	4,411	72	1.6
1940-45	+17%	-15%	+7%	-83%	

(Figures in thousands of workers)
SOURCES: Dominion Bureau of Statistics, *Canada Year Book*, 1954.

Canada's balance of payments continued its positive performance although concern surfaced early during the conflict on the shortfall in the country's U.S. dollar holdings. The question which loomed large was how could the Canadian government convert its vast sterling surplus into U.S. dollars. Early in 1940, the Exchange Fund account had run out of dollars and Towers recommended to the Government that the Bank of Canada's gold holdings be sold to the newly created Foreign Exchange Control Board in exchange for a $300 million issue of 90 day treasury bills. This was necessitated in spite of the receipt of $250 million in gold from the British Treasury as well as the repatriation of $125 million of Canadian issuer securities from London. Britain's deficit with Canada became so extensive that by 1942 Canada gave a one billion dollar gift of assistance to be used for purchases in Canada. Some of the pressures arising from the imbalance in Canada's trade relations with the United States and Britain were resolved in April 1941 with the Hyde Park agreements. Under the agreement, Canada's war purchases for Great Britain were subject to lend-lease arrangements reducing Canada's needs for U.S. dollars. America's pledge to buy certain strategic materials from Canada, including aluminum and ships, also relieved the currency drain.

Resumption of borrowing in New York during 1942 also permitted relief although Canada's requirements were met almost entirely in the domestic market over the war's duration. Total exports grew from $1.8 billion to $4.5 billion while imports grew more slowly peaking at $3.5 billion in 1944.

TABLE 3.12

Canadian Balance of Payments, 1940-1945

YEAR	Current Account (1)	Current Receipts (2)	Current Expenditures (3)	U.S. Current Account (4)	U.K. Current Account (5)	Net New Issues (Retirements (6)	Change Foreign Reserves (7)
1940	+149	1,776	1,627	-292	+343	-41	-79
1941	+491	2,458	1,967	-318	+734	-31	-160
1942	+199	3,376	2,275	-180	+1,223	-25	+144
1943	+688	4,064	2,858	-19	+1,149	-162	+364
1944	+1,018	4,557	3,539	+31	+746	- 74	+278
1945	+688	4,456	2,910	+36	+747	-88	+667

(in $millions Canadian)

SOURCES: Columns (1)-(3) Dominion Bureau of Statistics, *Canada Year Book*, 1954

The financial demands of war substantially broadened the tax base with income taxpayers growing from 300,000 pre-war to over 2,000,000 by 1944. The Government's general objective to finance one-half of its war expenditures through taxation was largely achieved and Canada's performance in this respect compares favourably with that of Great Britain and the United States.[210] The deliberate, controlled reduction of interest rates throughout the conflict and the Dominion's reliance on short-term financing at one per cent or less, meant that interest charges increased by only 250 per cent despite a four-fold increase in the debt outstanding. As Table 3.13 reveals, the massive expenditures on the war resulted in a dramatic decline in the proportion of government expenditure devoted to servicing the debt (Column 6).

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[210]Higgins, pp. 5-6.

TABLE 3.13

Dominion Government Finance, 1940-1945

YEAR	Total Current Expend.* (1)	Total Current Revenues (2)	Surplus / Deficit (3)	Interest Charges (4)	Surplus Deficit % of Total Expend. (5)	Interest % of Total Expend. (6)
1940	998	856	-140	137	-14.0	13.7
1941	1535	1493	-27	158	-1.8	10.3
1942	3737	2010	-1723	178	-46.1	4.8
1943	4352	2435	-1943	246	-44.6	5.7
1944	5285	2576	-2709	304	-51.3	5.6
1945	4284	2431	-1832	379	-42.8	8.8
1940-45	329%	+184%	---	+177%		

(in $millions Canadian)

SOURCES:- Column (l) CANSIM Mini-series identifier D 30592, Column (2) D 30555, (3) D 30610, (4) D 30581.

* *Excludes* certain transfers to other governments.

Provincial public finance was characterized by a slow but steady growth in expenditures, a relatively buoyant rise in revenues, and small surpluses in sharp contrast with the massive federal deficits. The provinces deferred to the federal government's all-embracing command over the economy's capital and manpower by putting on hold major hydro-electric and other capital projects as new capital borrowing was reduced to a trickle. The anarchy of provincial taxation practices was ameliorated somewhat through the federal government's initiative in "renting" the main tax sources of provinces and then turning back over a proportion based on an agreed formula.

TABLE 3.14

Provincial Government Finance, 1940-1945

YEAR	Total Current Expend* (1)	Total Current Revenues (2)	Surplus Deficit (1)-(2) (3)	Interest Charges (4)	Surplus Deficit % of Total Expend. (5)	Interest % of Total Expend. (6)
1940	359	412	+ 53	74	+14.8	20.6
1941	362	418	+56	74	+15.5	20.4
1942	368	470	+102	75	+27.8	20.4
1943	390	491	+101	72	+25.9	18.4
1944	445	515	+70	71	+15.7	16.0
1945	476	586	+110	89	+23.1	18.7

(in $millions Canadian)

SOURCES:- Column (l) CANSIM Mini-series identifier D 30592, Column (2) D 30555, Column (4) D 30581.

* *Excludes* transfers to other levels of government.

Interest rates continued their decline during the war. Apart from the early nervousness of the markets readjusting to the new conditions in 1939 and 1940, rates were extremely stable throughout the conflict, an indication that the rates were, in effect, administered rates. By the end of 1945, both long term rates (2.83 per cent) and short-term treasury bill rates (0.36 per cent) reached lows for this century. The differential between long and short-term money rates, some 250 basis points, remained fairly constant throughout the war. The downward trend was consistent with the Government's declared objective that it would not borrow at the rates that had prevailed during the Great War. The controlled nature of the decline is indicative of the role played by the Department of Finance as the policy-setting ministry and the Bank of Canada as the implementer in this policy of cheap money.[211]

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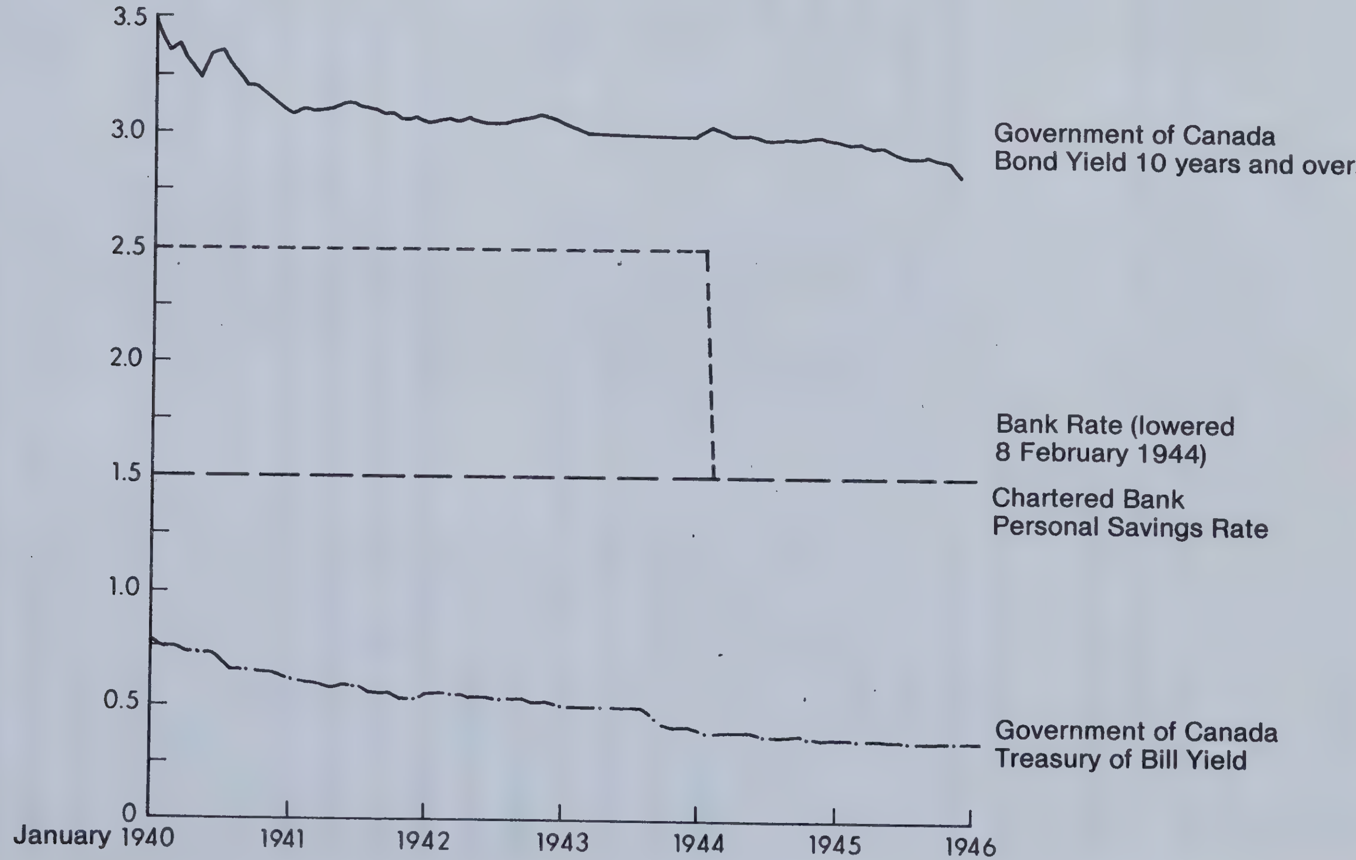
[211]Deputy Minister Clark was the main driving force behind reducing interest rates. In September 1939, Clark told visiting life insurance executives that a "4 per cent rate would create a revolution in this country." Clark to Ralston, 18 September 1939, *Public Archives of Canada*, RG 19, Volume 3978, File F-1-11. Towers who was much closer to the securities market tended to be more reluctant to press the case for lower interest rates early on in his tenure though subsequently he championed the cause for lower rates.

Figure 3.2 Government of Canada Bond Yields



Sources: Cansim Mini-Series Identifiers – Bank Rate B 14006, Long-Term Bonds B 14013, Treasury Bills B 14007

During the war, real rates of return narrowed from the levels of five to ten per cent during the depression and inflation during 1940 and 1941 eroded the incomes of the *rentier* class. Given the 18 per cent rise in the consumer price level throughout the war, the holder of a long-term bond yielding three per cent received a neglible rate of return over that period.

In August 1944, the Bank Rate was reduced a full percentage point from 2.5 per cent to 1.5 per cent. This move was premised on the assumption that cheap money was essential to provide industry in the process of reconverting plant and equipment to peacetime enterprises, with the lowest possible financing costs. Towers stressed that this change did not signal any fundamental reorientation of monetary policy. The Governor earlier declared that he saw no immediate need for higher interest rates unless consumption and capital investment activity grew at unacceptably high rates in the post-war period.[212]

Summary

The main economic trends included a quadrupling of federal government expenditure and a near doubling of national income. This development led to extremely heavy borrowing and taxation which was accompanied by wage and price controls, an administered interest rate and a moderate rate of inflation which occurred during 1940 and 1941. Foreign exchange shortages (U.S. dollars) were handled through another control board operating with the co-operation of Canada's chartered banks and by April 1941 an arrangement with the U.S. was signed to improve Canada's financial situation in procuring materiel for Britain from the Americans. Unemployment was virtually extinguished during mobilization with the government ordering all able-bodied workers to work on a full-time basis where needed.

The Post-War Period: 1946-1952

The main problems which plagued the Canadian economy during the period were inflation and the threat of unemployment. In Canada, the United States, and Great Britain, plans were well advanced before the surrender to create a viable international monetary order and to promote the necessary business confidence through the introduction of "full

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[212] *Annual Report of the Governor of the Bank of Canada and Statement of Accounts*, (Ottawa: 10 February 1944), p. 5.

employment" policies. The bias towards full employment was obviously premised on the fear that a return to the economic chaos and social turmoil of the thirties would threaten the very fabric of the Western capitalist economies leading to the undermining of political institutions.[213] Any analysis of the early post-war period therefore must proceed on the assumption that the government would err in the direction of inflation as against unemployment and therefore saw low cost money as a mechanism for sustaining economic growth. Complicating the pursuit of full employment was the very high volume of debt issued through the war and held by the general public. With the lifting of price, wage, and production controls beginning in 1946, a consumer-oriented boom financed, in part, by the selling of Victory Bonds was widely predicted. This development, combined with banks liquidating their securities to finance business credit would likely force up interest rates. Given these considerations, the Government was urged to maintain existing levels of taxation to run up large surpluses to purchase the bonds held by the public and in the banking system. This programme, in conjunction with a moderate rise in interest rates, was recommended to nip inflation in the bud.[214] Though the Dominion did run large surpluses throughout the period, economic policy directed at attacking inflation was undermined by the Bank and ultimately, the Government's conscious decision to keep interest rates down early in the period. As will be shown later, this prejudice against allowing rates to rise deliberately favoured the debtor Dominion Government and also was the product of a moral commitment made to Victory Bond holders during the war that they would receive 100 cents on the dollar when they sold their *marketable* bonds.

Government expenditure declined during the 1946 to 1948 period but thereafter grew rapidly, doubling between 1948 and 1952. This growth was overshadowed by a massive boom in business capital formation which quadrupled in eight years. This steady and massive increase was facilitated by the Dominion's policy of postponing some capital

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[213] Victor Quelch, the Social Credit M.P. from Acadia in March 1947 referred to a talk given by W.C. Clark to businessmen at the Chateau Montobello in October 1942. Clark gave his audience the following preview of what post-war economic policy might be:
"What will be needed is to safeguard against deflation, not to prevent inflation. If we are to avoid a long depression and mass unemployment, the policy required will be one of stimulation of the economy, one that will create expansionist tendencies, one that will provide incentives to expansion, one that will encourage the consumer to spend and expand his purchasing power, in short, one which will keep the national income from falling to abnormally low levels." Cited in House of Commons, *Debates*, 20th Parliament, 3rd Session, 10 March 1947, p. 1220.
[214] D.C. MacGregor, 1947, pp. 171-173 and R. Craig McIvor, 1948, pp. 92-93.

projects.[215] This boom was heightened by the banks tendency to lend funds for longer-term capital projects which more properly should have been financing from the sale of debt or equity capital.[216] Even with the Dominion putting projects on hold, the price index for capital projects shot up well above that experienced in other economic sectors (Table 3.17).

TABLE 3.15

National Income 1946-1952

YEAR	Govt. Expend.* (1)	Fixed Capital Formation (2)	Personal Consumption (3)	Net National Income Factor Cost (4)	GNP Market Prices (5)
1946	1,796	1,338	8,031	9,551	11,850
1947	1,541	2,085	9,090	10,361	13,165
1948	1,797	2,619	10,085	12,003	15,120
1949	2,127	3,032	10,923	12,905	16,343
1950	2,344	3,348	12,026	14,161	18,006
1951	3,271	3,959	13,460	16,588	21,170
1952	4,279	4,451	14,781	18,654	23,995

(In $ millions Canadian)
SOURCES: Dominion Bureau of Statistics, *National Accounts- Income and Expenditure, 1926-1956,* Columns 1-3, Table 2, Columns 4, 5, Table 1.
* *Excludes* tranfers and subsidies to other governments.

From 1946 to 1948, consumer credit and consumption rose by 25 per cent. Consumer prices increased at a similar pace prompting the appointment of the Royal Commissions on Prices, chaired by Professor C.A. Curtis, in February 1948. The commissioners were loathe to point the finger at any one group responsible, but they did feel that taxes were too low, budget surpluses weren't sufficiently large to drain off purchasing power, and monetary policy was regarded as being too easy.[217] The latter policy was clearly prompted by the authorities' desire to keep interest costs within reason and to prevent a recurrence of depression.

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[215]See Irene M. Spry, "The Royal Commission on Prices," *Canadian Journal of Economics and Political Science,* Volume 17, No. 1 (February 1951), pp. 79.
[216]*Annual Report of the Governor of the Bank of Canada and Statement of Accounts,* 1948, (Ottawa: 11 February 1949), p. 79.
[217]Spry, 1951, pp. 79-83 and McIvor and Panabaker, 1954, pp. 212-215.

TABLE 3.16

Distribution of National Income, 1946-1952

YEAR	Wages, Salaries (1)	Corp. Profits before Tax (2)	Rental, Interest, Misc Income (3)	Agric. Income (4)	Non-Agricultural Businesses (5)
1946	57.4	13.3	6.1	11.1	11.2
1947	61.8	15.1	5.7	10.8	11.3
1948	61.7	14.3	5.4	11.5	10.6
1949	62.0	12.1	5.4	9.7	10.8
1950	60.8	15.0	6.3	9.3	10.2
1951	60.9	14.8	6.1	11.7	9.2
1952	60.1	12.7	6.3	10.5	8.4

SOURCES: Dominion Bureau of Statistics, *National Accounts- Income and Expenditures, 1926-1956*, pp. 26-27.

TABLE 3.17
Gross National Expenditure, Implicit Price Indices
(1949=100)

YEAR	Personal Consumptn. (1)	Govt Expend. (2)	Fixed Capital Formation (3)	Imports (4)	Exports (5)
1946	77.8	78.3	75.2	77.4	78.0
1947	85.3	83.3	83.5	86.7	87.9
1948	96.5	94.5	95.0	96.9	96.6
1949	100.0	100.0	100.0	100.0	100.0
1950	103.3	104.5	105.7	107.3	104.6
1951	113.9	116.6	119.9	119.8	116.2
1952	117.8	121.7	124.1	110.6	114.9

SOURCES: Dominion Bureau of Statistics, *National Accounts- Income and Expenditure, 1926-1956*, Table 6.

While Canada was not immune from the inflation that was feared and predicted by many observers, employment trends continued to be generally favourable. The addition of nearly 800,000 jobs in the non-agricultural sector was partially offset by a major decline in agricultural employment-a drop of nearly 200,000 workers in six years. Unemployment predictably rose during demobilization but this trend was arrested during the consumer-fed boom of 1947-48. Afterwards, unemployment began to build up until the Korean War broke out peaking at 400,000 unemployed during the winter of 1949-50.[218]

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[218]See speech of Ross Thatcher, C.C.F. M.P. and future Liberal leader of Saskatchewan, House of Commons, *Debates*, 21st Parliament, 2nd Session, 24 April 1950, p. 1854.

TABLE 3.18

Employment 1946-1952

YEAR	Non-Agric. Employment (1)	Agricult. Employment (2)	Total Employment (3)	Unemployed (4)	Unemployment Rate (5)
1946	3,438	1,261	4,699	125	2.6
1947	3,660	1,163	4,823	91	1.9
1948	3,730	1,177	4,915	81	1.6
1949	3,860	1,100	4,970	101	2.0
1950	3,975	1,062	5,037	144	2.8
1951	4,175	997	5,172	83	1.6
1952	4,298	924	5,222	107	2.0

(Figures in thousands of workers)
SOURCES: Dominion Bureau of Statistics, *Canada Year Book*, 1954.

Canada's trade position resumed its usual pattern after the war, that is to say, its chronic trade deficit with the United States. Imports, relative to exports, continued to grow with this trend particularly pronounced in 1947 when imports grew a whopping 20 per cent as against and 11 per cent rise in exports. By November 1947, Canada's official reserves were dangerously low which allowed the Government virtually no room in which to manoeuvre. The resulting exchange crisis was exacerbated by the continuing repatriation of foreign debts and by a reduction of exports to the United Kingdom. After 1948 a decided improvement in Canada's reserves is observed as a resumption of selling bonds abroad coincided with a comprehensive programme introduced in 1948 to preserve Canada's U.S. dollar reserves by limiting travel and imports from the dollar zone. During 1950, speculators sensing the prospect of an upward revaluation of the Canadian dollar started to buy Canadian dollars. Between June and October 1950, nearly $700 million poured in forcing the Government to sell over $300 million in its securities holdings to meet the demand for Canadian dollars.[219] On October second, the Government, in reponse to this massive inflow, allowed the dollar to float and the dollar soon moved to above $1.00 in U.S. funds.[220]

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[219]See G.F. Towers, "Review of Post-War Monetary Policy," in Neufeld (ed.), 1964, p. 269.
[220]For a good review of Canada's floating dollar see Paul Wonnacott, *The Floating Canadian Dollar: Exchange Flexibility and Monetary Independence*, (Washington: 1972), pp. 24-27.

TABLE 3.19

Canadian Balance of Payments, 1946-1952

YEAR	Current Account (1)	Current Receipts (2)	Current Expenditures (3)	U.S. Current Account (4)	U.K. Current Account (5)	Net New Issues (Retirements (6)	Change Foreign Reserves (7)
1946	+363	3,365	2,905	−607	+500	−238	−251
1947	+ 49	3,748	3,661	−1,134	+633	−269	−743
1948	+451	4,147	3,673	−393	+ 486	+36	+496
1949	+177	4,089	3,906	−601	+ 446	− 42	+134
1950	−334	4,297	4,569	−400	+ 24	−74	+694
1951	−517	5,311	5,674	−951	+223	+227	+39
1952	+51	5,859	5,495	−853	+337	+230	+80
1946−52		+74%	+89%				

(in $millions Canadian)

SOURCES: Columns (1)−(3) Dominion Bureau of Statistics, *Canada Year Book*, 1954

Dominion Government finance was characterized by substantial surpluses used to retire and /or purchase debt as well as substantial revenue and expenditure growth, the latter occuring after 1949 and is associated with the Cold War military build−up. The debt decreased by almost $4 billion yet interest costs began to rise early in 1948 illustrating the effect of the relatively small upward shift in the cost of money on the financial condition of very large debtors. Still, with the retirement of debts and the growth of expenditures, interest charges as a portion of expenditures fell from their peak of nearly 24 per cent in 1948, declining therefter. Provincial government finance, grew relative to federal expenditures due to demobilization. Capital projects, postponed during the war, were rekindled and buoyant revenues produced large surpluses, relative to those surpluses enjoyed during the war period.

TABLE 3.20

Dominion Government Finance, 1946-1952

YEAR	Total Current Expend.* (1)	Total Current Revenues (2)	Surplus / Deficit (3)	Interest Charges (4)	Surplus Deficit % of Total Expend. (5)	Interest % of Total Expend. (6)
1946	2,980	2,595	−245	444	−8.2	14.9
1947	2,125	2,733	+687	453	+32.3	21.3
1948	1,905	2,667	+765	453	+40.2	23.8
1949	2,077	2,645	+484	461	+23.3	22.2
1950	2,291	2,962	+650	427	+28.4	18.6
1951	3,104	4,099	+971	486	+31.3	15.7
1952	4,299	4,616	+195	515	+4.5	12.0
1946−52	+44%	+78%		+16%		

(in $millions Canadian)

SOURCES:− Column (l) CANSIM Mini−series identifier D 30592, (2) D 30555, (3) D 30610, (4) D 30581.

* *Excludes* certain transfers to other governments.

TABLE 3.21
Provincial Government Finance, 1946-1952

YEAR	Total Current Expend* (1)	Total Current Revenues (2)	Surplus Deficit (1)−(2) (3)	Interest Charges (4)	Surplus Deficit % of Total Expend. (5)	Interest % of Total Expend. (6)
1946	538	686	+148	70	+27.5	13.0
1947	652	855	+203	68	+31.1	10.4
1948	794	949	+155	68	+19.5	8.6
1949	968	1023	+55	72	+5.7	7.4
1950	1034	1164	+130	75	+12.6	7.3
1951	1179	1332	+153	78	+13.0	6.6
1952	1152	1422	+270	83	+23.4	7.2
1946−5	114%	107%		19%		
1928−39	+118%	+91%	−	+74.4%		

(in $millions Canadian)

SOURCES:− Column (l) CANSIM Mini−series identifier D 30592, Column (2) D 30555, Column (4) D 30581.

The progress of short−term interest rates was remarkably constant during 1947 and 1948 being apparently immune to the shocks associated with the exchange crisis. In fact, the treasury bill rate remained frozen at .47 per cent between April 1947 and September 1948. A small, administered rise was observable during the second quarter of

1949 with rates stabilizing until the summer of 1950 when rates were permitted to move upward during the Korean conflict. At the long end of the market, selling pressures became evident as early as 1947 with holders disposing of their portfolios to the central bank and the Dominion which were buying bonds to prevent a break in the market.[221] After this initial rise of some 25 basis points, the long term market was stabilized until August 1950 when bond yields moved upward in a step-like formation. The rise in both short and long-term rates coincided with the beginning of rearmament and also was used by the government as a signal to resort to a major effort to combat rising prices by applying monetary techniques. The follwing February, the Bank took steps to restrict credit by formally requesting the chartered banks to curtail consumer lending on luxury goods and services.[222]

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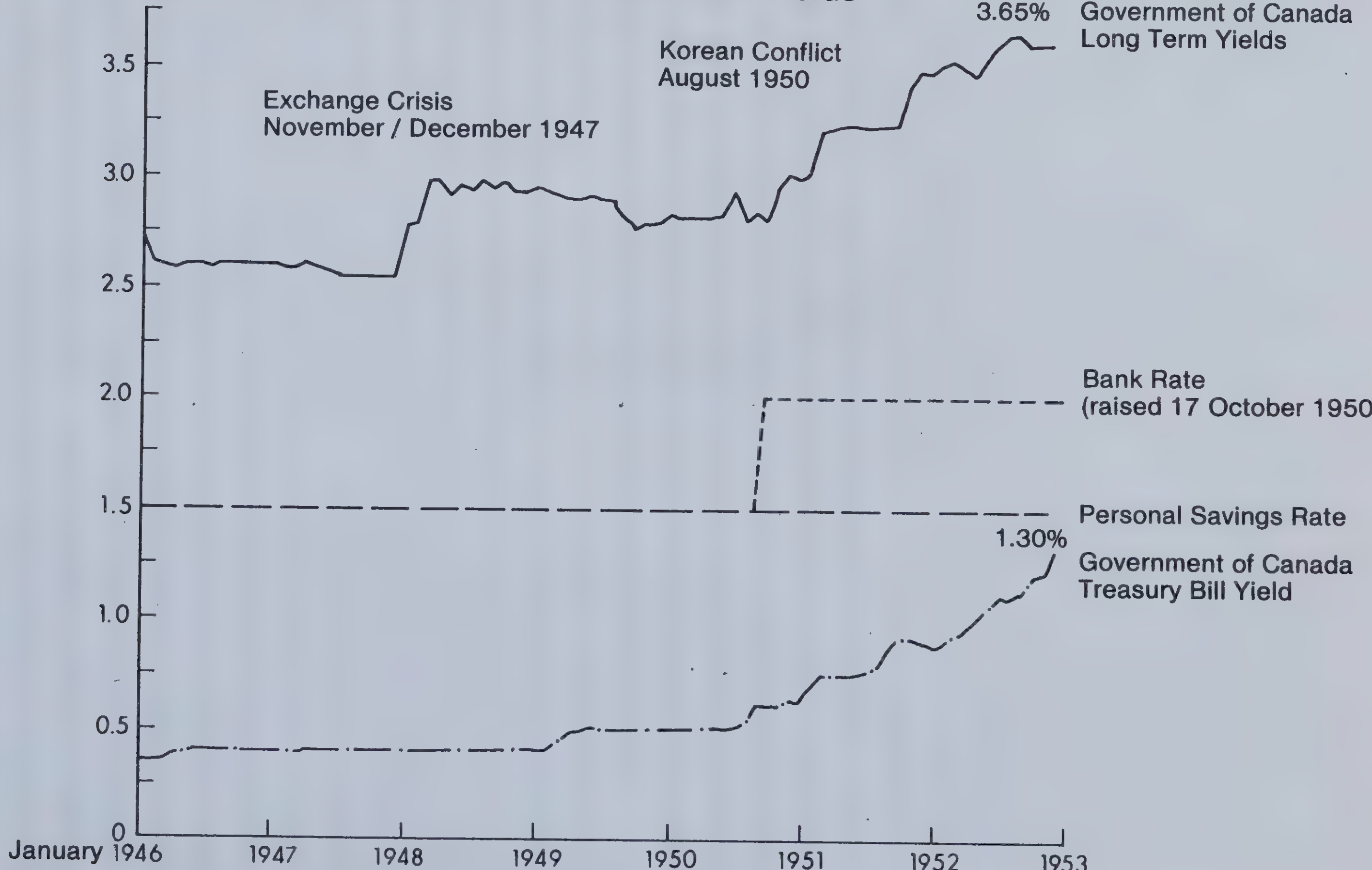
[221]Towers Memoranda, No. 561, 5 January 1948, "Meeting with Minister of Finance and Dr. Clark," *Bank of Canada Archives*,
[222]*Annual Report of the Governor of the Bank of Canada and Statement of Accounts*, 1951, (Ottawa: 11 February 1952), pp. 8-13.

Figure 3.3 Government of Canada Bond Yields



Sources: Cansim Mini-Series Identifiers – Bank Rate B 14006, Long-term Bonds B 14013, Treasury Bills B 14007

In general, the early post–war period was characterized by growing prosperity and rising economic expectations. Accompanying this bullish consumer and business mood was a rising price level which led to falling bond prices and rising bond yields. Canada's employment picture remained healthly with minor fluctuations associated with demobilization and the Korean war preparations. Canada's trade position deteriorated sharply in 1947, necessitating a return to controls on travel and imports from the United States. Inflation, not unemployment was the issue which preoccupied Canadians but the fear of a recurrence of massive unemployment dominated the formulation of economic policy for most of the period. The fight against inflation was complicated by the existence of at least six billion dollars of war loans in the hands of the "general public" representing a latent purchasing power of enormous inflationary consequence. The Government's policy of purchasing the debt through a special "X Account" and its gradual retirement of the debt held by the banking system was consistent with academic counsel though a general consensus evolved that the Government had not pursued this policy as vigorously as it ought to have.

This overview completes our economic survey of the period. Each sub–period, it should be emphasized, was radically different in economic and political terms, and called for vastly different economic and financial policies to combat unemployment, deflation, or inflation. The trauma of the depression left a lasting imprint on the minds of the post–war policy–makers who were determined to prevent another bout of deflationary depression. A trend towards greater governmental administration and control over the capital markets is also observable. Finally, greater government involvement in economic affairs was consummated with government expenditures after the war stabilizing at a level well above the pre–depression level of 10 per cent of G.N.P.

IV. A POLITICAL PERSPECTIVE

Although it is true that debt management was never the subject of intense scrutiny in Parliament, nonetheless, there was frequent debate on the burden of the debt and the need for lowering interest rates. In this chapter, the political dimension of debt management is explored through an evaluation of the economic and political philosophies of the two mainstream parties and the Co-operative Commonwealth Federation and the Social Credit party. There will also be some reference made through the course of this chapter to the contributions made by Progressive and United Farmers of Alberta party spokesmen. (These parties essentially disentegrated after the 1935 general election.) This analysis will be based primarily on the House of Commons *Debates* and secondarily on historical accounts of the period. A brief examination of the views of Senators on this governmental function is contained in the final section.

Introduction

Before commencing this survey several general observations must be made. First of all, underlying the debates about a lower interest rate was the relationship between the rates paid to government bondholders, bank depositors, and rates charged private borrowers. Those representatives most sensitive to this relationship tended to come from the debtor regions, usually farming communities decimated by falling commodity prices and squeezed by the fixed debt charges negotiated when grain and other commodity prices were considerably higher. Members of Parliament including G.G. Coote (Progressive, Macleod) and William Irvine (U.F.A., Wetaskiwin) and Social Crediters J.C. Landeryou (Calgary East), J.H. Blackmore (Lethbridge), and Victor Quelch (Acadia) in addition to C.C.F. leaders J.S. Woodsworth (Winnipeg North Centre) and M.J Coldwell (Rosetown-Biggar) were all notable in their unrelenting attacks on the Government's tacit support of the "money power", i.e. the banks, whose conservative loan policies and high profits were, in their view, an affront to the Canadian people. This position was articulated by Bill Irvine during the debate on the Bank Act revision in 1934.

> The resolution is predicated upon a well-known, and I think indisputable fact, that it is the function of the state to handle the financial affairs of the state; that the right and power to issue currency and to control credit originally was vested in the state, and, constitutionally, as far as we know is there yet. But something has happened in Canada. I am not clear as to who made it happen, nor do I know the intricacies of the process by which it was brought about, but

> it does appear now that the authority to control credit is no longer in the hands of the state, at least directly. It has been delegated to another authority. That authority is permitted now to carry on the credit and financial services of the state for private gain.[223]

Secondly, the old-line parties were normally reactive, orthodox and cautious in matters of finance while in office and opportunistic and partisan while in opposition. Mackenzie King and the Liberals' sporadic attacks against the "money power" which began early in 1933 were carefully tailored to meet the mood of an increasingly desperate population and to capitalize on Bennett's decision to create a *privately owned* central bank along the lines of the Bank of England.[224] Back in government, King's compromise nationalization of the Bank of Canada in 1936 was an obvious attempt to satisfy the demands of western farmers and at the same time avoid alienating the financial community.[225] Prime Minister King's sudden nationalization of the Bank on the eve of the June 1938 Saskatchewan general election was generally regarded as politically motivated.[226] Ambivalence greeted this proposal at caucus and King was deeply worried about his orthodox Finance Minister's commitment to see such a measure passed by Parliament.[227]

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[223] House of Commons, *Debates*, 17th Parliament, 5th Session, 30 January 1934, p. 130.
[224] See H. Blair Neatby's *William Lyon Mackenzie King: 1932-1939, The Prism of Unity*, (Toronto and Buffalo: 1976), pp. 30–34. Professor Curtis of Queen's prepared a memorandum for King in 1932 on a central bank. According to Professor Neatby, King was "delighted" with the analysis for *"a central bank was an institution, not a policy.* Opponents of inflation might be persuaded to support the idea of establishing a central bank because it could provide some control over credit *without interfering unduly with private enterprise* and would not necessarily inflate the supply of money." p. 34. King was also impressed with Jimmy Gardiner's political maxim that electoral popularity in the west could be gained by hammering the Tories and the banks. p. 30. (emphasis added).
[225] The 1936 amendment authorized the issue of 102,000 Class B shares to be held by the Finance Minister and the appointment of six additional directors representing the Class B shareholder. (1 Edward VIII, Statutes of Canada, 1936, Chapter 22) Under the *Bank of Canada Amendment Act, 1938*, Class A shares previously held by the public were purchased at $59.20 per share up from the issue price of $50.00. (2 George VI, Statutes of Canada, 1938, Chapter 42)
[226] According to Linda M. Grayson, King for some bizarre reason, believed that R.B. Bennett was about to introduce a pre-emptive motion to nationalize the central bank. See *The Formation of the Bank of Canada*, Unpublished Ph.D. dissertation, University of Toronto, Department of History, 1974, pp. 313–316. See also A.F.W. Plumptre, *Central Banking in the Dominions*, (Toronto: 1940), p. 149, Mallory, 1976, pp. 107–108. Senator Meighen aptly labelled the bill "an act to win the Saskatchewan election." Senate, *Debates*, 18th Parliament, 3rd Session, 29 June 1938, p. 555.
[227] Grayson, 1974, p. 317.

The Conservative Party

Predictably, the party in power is obliged, in order to retain "investor confidence", to comply with the expectations of the capital markets to reduce government spending and taxes. The actions of both Conservative Finance Ministers, first R.B. Bennett and then Edgar Rhodes, did conform, in the main, with the unstated norms of the financial marketplace. One of the very first indications that Bennett and his party[228] would meet the expectations of the financial community came in the wake of Britain's abandonment of the gold standard. With the rapid fall in bond prices in September and October 1931, Bennett quietly passed an order-in-council making unnecessary a write-down of security values on banks' balance sheets.[229] G.G. Coote (Progressive, MacLeod), perhaps the most intelligent student on monetary questions and of Canadian banking in the House, used this transaction to attack high interest rates. Exorbitant rates were, in Coote's opinion, harming provincial and municipal finance and ruining the national economy.[230]

The most obvious instance of Bennett swearing allegiance to the existing financial and economic order came in a speech delivered in March of 1934. To R.B. Bennett, millionaire lawyer- Prime Minister and former director of The Royal Bank of Canada, Canada's "national character" could be gauged in terms of its ability to faithfully meet its outstanding debt obligations.

> We have been responsible for the effort which has been made to maintain the financial integrity of Canada. I have heard jeers that we should care more for our people than for our credit, *but I wonder if there is an hon. member familar with business who does not know that the salvation of the people depends upon the credit which is maintained for them.* How are we to secure the very things which we need in this country if we destroy our character? *Our character is our credit and our credit is our character.*[231]

In developing this theme, R.B. Bennett acknowledged that Canada's thirst for new capital imports could only be quenched if default and repudiation were spurned. In keeping trust with foreign creditors, in preserving Canada's credit rating, the public interest would be

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[228]Some observers claimed that Bennett's financial support made it "his" party in more than one respect.

[229] P.C. 2693, 27 October 1931 which authorized valuation at current market prices on 31 August 1931.

[230]House of Commons, *Debates*, 17th Parliament, 3rd Session, 20 April 1932, p. 2214. Coote eventually served on the Board of Directors and Executive Committee of the Bank of Canada as the Alberta member for many years.

[231]House of Commons, *Debates*, 17th Parliament, 5th Session, 19 March 1934, p. 1627. (emphasis added)

served.[232] Canada's dependence on the goodwill of foreign bondholders made the Dominion doubly sensitive to the need to keep a tight rein on the borrowing behaviour of subordinate governments and on their proclamations about capital in general. The Dominion's vulnerability in this matter was painfully apparent during the Spring of 1935 when Premier Mitchell Hepburn of Ontario cancelled hydro purchase contracts with several major, Quebec power companies.[233] This unexpected move led to the abandonment of a conversion operation in London and to Bennett's denunciation of the Liberal premier in the House.[234]

The views of Bennett were also shared by his successor in the Finance portfolio, Edgar Rhodes who, when assessing the interest rate situation in 1935, opined:

> It appeared that the time was fast approaching where practically all public bodies could secure the advantages of refunding outstanding issues at substantially lower interest rates, but a temporary clogging of the market and certain unfortunate, widely heralded statements[235] have clouded the outlook for the time being. It is to be hoped that this situation is only a temporary one, *but it behooves all debtors to remember that credit is a tender plant and must be carefully cultivated.*[236]

Nevertheless, it would not be correct to regard Rhodes and Bennett as putty in the bankers' hands. As the Depression deepened, the Government seemed more open to using its constitutional powers to respond to the grave economic crisis. In November 1932, the Government sold treasury bills to the banks which were pledged in return for a $35,000,000 increase in Dominion notes held by the banks. This operation, judged to be a failure because other advances under the Finance Act were repaid, was followed by another manoeuvre in May 1933 aimed at lowering the Dominion's interest charges. In announcing a reduction in the rates paid on post office savings bank accounts, Rhodes was careful to state "the Dominion government is not charged with the duty of determining the rates of interest allowed by chartered banks on deposits nor with the rate of interest

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[232] *Ibid*, pp. 1629-1632.
[233] "Bond Trading at Standstill," *The Monetary Times*, 4 May 1935, p. 22 which observed "interest high in London" about the Ontario-Hydro situation.
[234] House of Commons, *Debates*, 17th Parliament, 6th Session, 21 May 1935, p. 2924 and "Canada's Credit in London," *The Monetary Times*, 25 May 1935, p. 6.
[235] These "unfortunate, widely heralded statements" include the utterances of one Ian Mackenzie, a Liberal M.P. from Vancouver who called for a reduction of rates on outstanding debts to 2.5 per cent, the increase of currency by some $340 million, and negotiations with foreign creditors to lower rates on foreign-pay debts.
[236] House of Commons, *Debates*, 17th Parliament, 6th Session, 22 March 1935, p. 1965. (emphasis added)

charged their customers for banking accommodation."[237] This was a curious admission for section 91 of the *Bank Act* set the maximum legal rate of interest charged by a bank at seven per cent and the B.N.A. Act granted the Dominion Parliament exclusive jurisdiction over banking, interest, currency and credit. Rhodes did acknowledge though the Government's belief that lower rates were essential to business and trade and, as we shall discover, to government finance as well.

In opposition, the Tories' orthodoxy was much in evidence, notably their exception to excessive government spending and rising government deficits. H.H. Stevens, one-time Conservative minister and maverick Tory stated that "the savings of the Canadian people have been diverted from private enterprise into government financing, expansion of activity from a private industrial standpoint has been impeded."[238] These misgivings were shared by Tory M.P.s J. Earl Lawson (York South) and A.B. Hyndman (Carleton) who pointed to government profligacy and heavy taxation as a cause of the continuing depression.[239] Hyndman shared the view of Sir Edward Beatty, C.P.R. czar and J.A. Marsh (Conservative, Hamilton West) that borrowing on current account, that is to cover what might be termed operating expenses, was dangerous.[240] These Tories then shared the "Ricardian" notion of the burden of the public debt, that is, debt represented the opportunity cost of providing capital to government when the private sector could use that capital more productively.

The Conservatives also tended to be more sensitive to the negative aspects of foreign borrowing than the other parties, although this was not of central concern to the party. Bennett, when addressing the problems of default in the wake of Alberta's decision to only pay one-half of the interest and defer payment of principal, reiterated the importance of maintaining a strong credit position in foreign markets, particularly in the United States.[241] This orientation was evident during the war when R.B. Hanson (York Sunbury), acting Conservative opposition leader, wanted to know more about the Dominion's indebtedness to the United States. He then went on to voice opposition to foreign borrowings in general.

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[237]House of Commons, *Debates*, 17th Parliament, 4th Session, 11 May 1933, p. 4854.
[238]House of Commons, *Debates*, 18th Parliament, 4th Session, 2 May 1939, p. 3444.
[239]*Ibid*, 28 April 1939, p. 3351 and 1 May 1939, pp. 3340-41.
[240]*Ibid*, 1 May 1939, pp. 3340-41. See also W.A. Walsh (Conservative, Mount Royal), House of Commons, *Debates*, 18th Parliament, 2nd Session, 9 March 1937, p. 1606.
[241] House of Commons, *Debates*, 18th Parliament, 1st Session, 6 April 1936, pp. 1846-47.

> I hope this will be a salutary warning to all governments, no matter what their political complexion may be, *that the debt of the country should be held within the country. If held in Canada no very appreciable difficulties will arise in handling it. It is the debt we owe to the stranger which may cause us great anxiety in days to come.*[242]

The acting leader agreed with the developing consensus which distinguished between domestic and foreign-pay debts holding that internal debts did not pose as great a threat to the nation as did foreign-pay debts. External debts, on the other hand, led to complications especially in the fields of trade and foreign exchange. In Hanson's mind, an internally held and independently managed debt would permit the nation more autonomy in charting its own economic course.

The most forceful and partisan attack on the Government's debt management programme by the Tories came in November 1940 when Hanson blasted the Minister and his officials for the failure of the Second War Loan which Hanson described as a "flop".[243] In his sweeping attack, Hanson listed five reasons for the "flop" including (1) lack of war fervour, (2) lack of war casualties! (3)heavy taxation, (4) lack of involvement by provincial war finance committees, and (5) the public's perception that government spending was, as usual, "extravagant". Hanson's analysis, though perhaps exaggerated, pointed to the deficiencies in the *organization* of the financial organization and the Savings' Committee. Much soul-searching went on after this campaign closed in spite of King's and others' statements that the War Loan was "handsomely oversubscribed" and therefore a success.[244] This episode once again confirms the Conservatives' classical position on government borrowing and the dangers of profligate public spending.

After the war, the focus of attention for the Tories shifted from concern respecting the efficiency of government spending to criticisms of government interest rate policies and budgetary performance. In the case of the former, the Tories demanded, to put it crudely, a made-in-New York, "market" interest rate policy. In the latter area, Colonel Drew and Donald Fleming were upset about Liberal budgeting which maintained high taxes and generated larger budget surpluses than originally forecast.

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[242]House of Commons, *Debates*, 19th Parliament, 3rd Session, 8 June 1942, p. 3134. (emphasis added)
[243]House of Commons, *Debates*, 19th Parliament, 2nd Session, 12 November 1940, p. 27.
[244] *Ibid*, pp. 52–53.

In 1947, J.M. Macdonnell, former General Manager of The National Trust Company and P.C. Finance critic, doubted the Government and central bank would be able to keep interest rates down given that rates were rising in New York. Macdonnell advocated an increase in interest rates by advancing the spurious argument that higher rates were necessary for the middle classes' economic well-being and the middle classes always acted as a preservative for democratic government.[245] Several months after Macdonnell raised this question, D.C. Abbott announced the signing of a $300 million U.S. loan from the Export-Import Bank of the United States (Eximbank). Before discussing this major loan to shore up Canada's sagging dollar, some background is necessary.

In July 1946, the Canadian dollar, which had been pegged at 90 cents U.S. during the war, was repegged at par. As interest rates climbed in New York during 1947, questions were raised in the House about Canada's interest rate policy. In responding to a question from Progressive Conservative A. Cockeram (York South) in April, Abbott replied coolly that the situation would "be handled as a matter of government policy which will be announced in due course."[246] In early June, Stanstead Conservative, J.T. Hackett asked the Minister for information on the level of Canada's official foreign exchange reserves. No information at this time was forthcoming.[247] Subsequently, it was revealed that during the summer of 1947, Canada was losing foreign exchange on the order of $70 million per month.[248]

At the opening of the Fourth Session in December 1947, made necessary by the exchange crisis, it was announced that Canada was seeking a $300,000,000 loan from Eximbank. John Bracken asked the Minister whether any terms or conditions would be attached to the loan, if any, as well as information on the present status of Canada's foreign reserves. Abbott dodged the question about reserves but stated categorically that no conditions had been placed on the loan.[249]

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[245]House of Commons, *Debates*, 20th Parliament, 3rd Session, 6 May 1947, pp. 2802-2803. Obviously, Macdonnell's vision of what the middle class was is considerably different from the usual conception of the social scientist. Macdonnell's quest for higher rates would have meant that the middle class would have difficulty financing the purchase of a home.

[246]House of Commons, *Debates*, 20th Parliament, 3rd Session, 24 April 1947, pp. 2357-2358.

[247]*Ibid*, 6 June 1947, pp. 3903-3904.

[248]Hon. D.C. Abbott in House of Commons, *Debates*, 20th Parliament, 4th Session, 25 June 1948, p. 5838.

[249]*Ibid*, 5 December 1947, p. 16.

On December 16th, Abbott announced to what must have been an incredulous House a series of drastic measures to conserve foreign exchange, *viz.* U.S. dollars. In underlining the urgency of the crisis, he drew to the Commons' attention Canada's shipment of $75 million in gold to the newly created International Monetary Fund and a $145 U.S. million loan repayment as factors which had aggravated the situation. The import restrictions announced were sweeping ranging from poultry and eggs to most household appliances, to cigarettes, soaps, and cosmetics. Quotas were also imposed on citrus fruits, vegetables, textiles, leather goods, among other products. A special excise tax on consumer durables was imposed and a $50 limit on travel expenditures while in the U.S. dollar area implemented.[250]

Abbott, in rationalizing the Government's continuing commitment to maintain the dollar at par (in U.S. funds) and not to allow the dollar to fall, which would certainly have pleased the export-producing industries and regions, argued that the inflationary consequences of devaluation would be devastating. "Anyone who suggests that depreciation is not an inflationary measure in times like these is living in a world of fantasy," claimed the Finance Minister somewhat defensively.[251] This statement, in many ways, summarizes succintly the Canadian policy on inflation, interest rates, exchange rates, and foreign borrowing of the Dominion over the succeeding 35 years. Instead of allowing the dollar to drop, thereby encouraging import substitution and export development, the Dominion pursued an approach which contemplated periodic, short-term borrowing operations to rectify what was to become a chronic capital and trade deficit with the United States.[252] The exchange crises of 1963 and 1978-79 are more recent examples of this policy which has mistakenly confused a high value of the dollar with a maintenance of a high standard of living and the prevention of the inflationary bogey-man.

In speaking to the $300 million loan, Abbott was well aware that this served only as a "temporary solution" which however came to be institutionalized as policy.

> It merely provides a supplement to our exchange reserves to take care of a temporary deficit until the constructive longer-run measures which are going into effect get into full operation and produce a more reasonable balance in our commercial and financial relationships with the dollar area. Not only does it give more time for the constructive solutions, but it also permits the adoption

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[250] *Ibid*, 16 December 1947, pp. 331-336.
[251] *Ibid*, p. 337.
[252] Under the I.M.F.'s rules, countryies were to remain on a fixed exchange standard. Still, this did not prevent Canada from devaluating in 1948.

> of a program less upsetting to business than would be necessary. Without the additional latitude which a loan provides, the program of restrictions would have to be much more severe which would cause undue dislocations to the Canadian economy and to many of our suppliers in the United States.[253]

This justification for an extraordinary implementation of an administrative regime of import–exports controls designed not to "upset business" was hardly in conformity with the facts.[254] Controls were being instituted after a short period of relatively free trade because of the procrastination of the Minister and his officials throughout the Summer and Fall who knew full–well the gravity of the situation.[255]

In providing interim details on the actual loan, Abbott observed that Eximbank, a government agency, and not private banks had been tapped because of "the magnitude of the sum required" and the necessity for a quick decision.[256] This was only partially true as we shall see for it was rather the rate of interest which was the stumbling block with American banks and, as the Minister indicated, the sum involved.[257] Curiously, at the time of this announcement, the rate of interest "was not known", though Abbott believed it to be "slightly above 1 7/8%."[258] The loan was repayable in "equal installments in three, four, and five years time."[259] The borrower was permitted to draw down the loan when required so, in a sense, this arrangement was similar to a line of credit with a bank. In June of 1948, Abbott informed the House that drawings to that date totalled $140 million.[260]

The significance of this debate from the point of view of Conservative economic philosophy was their insistence that the price of money should not be artificially maintained by the Government. By 1951, Graham Towers had come to recognize the

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[253] *Ibid*, pp. 336–337.
[254] This type of bureaucratic interference bothered King considerably. "I asked Council how we would act if we were in Opposition and the Government of the day was given arbitrary powers to decide on anything. I am afraid we may have to back away from a good many of the clauses that have been inserted." Cited in J.W. Pickersgill and D.F. Forster, *The Mackenzie King Record, Volume 4, 1947-1948*, (Toronto: 1970), p. 124.
[255] In early August, Towers and Lester Pearson met with Prime Minister King to discuss the looming exchange crisis. King granted Towers permission to initiate discussions with the U.S. Treasury Department, provided Abbott was in agreement. King recorded in his diary: "I pointed out, once we borrowed, we would find it increasingly difficult to loan abroad or make further advances for relief, etc. This may not be a misfortune. The sooner the country or more the Gov't realizes that we can't go on spending at will the better." Cited in Pickersgill and Forster, 1970, p. 84. This was at a time when the Dominion was enjoying one of its largest budget surpluses.
[256] House of Commons, *Debates*, 20th Parliament, 4th Session, 16 December 1947, p. 337.
[257] Towers Memoranda, No. 560, 4 December 1947, "Notes on discussions with banks and others in New York in regard to Canadian financing," *Bank of Canada Archives*.
[258] House of Commons, *Debates*, 20th Parliament, 4th Session, 16 December 1947, p. 337.
[259] *Ibid*.
[260] *Ibid*, 25 June 1948, p. 5838.

enormous difficulty in both keeping up the value of the Canadian dollar *and* at the same time limiting the rise of interest rates. (See Chapter V).

The second aspect of the Conservatives' line of attack dealt with the large, unanticipated surpluses destined for debt redemption. Under their new leader, George Drew, the Tories questioned the Government on its plans for debt retirement.[261] For Colonel George Drew, surpluses implied over–taxation giving the government free license to do whatever it wanted with the extra funds.

> The fact that the government is going to use that overtaxation or surplus, whatever you call it, for a particular purpose, as it has a legal right to do, does not justify the government obtaining the approval of a plan of taxation which will raise the money without parliament knowing that the money is to be raised for that particular purpose: that is my point. [262]

Drew maintained that no money should be issued from the Consolidated Revenue Fund without explicit parliamentary approval. That the Government intended to retire debts was a canard– Parliament must approve the reduction of the debt since the tax moneys flowed into the revenue fund and no moneys, even for debt retirement, could be paid out without Parliament's authorization.

Donald Fleming was also skeptical about the Government's newfound adherence to reduction of debt immediately after a general election. Fleming believed the people were "tired of these mostly unnecessary surpluses". Fleming later contradicted himself when he suggested that surpluses led to profligacy in spending before the end of the fiscal year. As an alternative, the Tories promised (and demanded) "a planned, not haphazard" debt reduction.[263] The foregoing illustrates a strong, contradictory impulse between spending for political gain and debt reduction for reasons of fiscal prudence and market conditions.

Summary

The Conservatives then subscribed to a fiscally orthodox approach to monetary and fiscal policy. Budgets ought to be balanced and taxes kept at relatively low levels. In keeping with this classical, traditional approach to the public finances, Conservatives exhibited more faith in market forces than did the other political parties.

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[261]Macdonnell, House of Commons, *Debates*, 21st Parliament, 4th Session, 16 April 1951, p. 2047 and Donald Fleming, House of Commons, *Debates*, 21st Parliament, 6th Session, 23 April 1952, p. 1532.

[262]House of Commons, *Debates*, 21st Parliament, 5th Session, 15 December 1951, p. 1999.

[263]*Ibid*, 24 October 1951, p. 357 and House of Commons, *Debates*, 21st Parliament, 6th Session, 23 April 1952, p. 1532.

The Liberal Party

In general, the attitude of the Liberal party to public debt and public borrowing under King was a pragmatic one reflecting the changing political and economic circumstances. This is apparent for when returned to power in 1935, the Government's financial policy evolved under the direction of Clark and Towers towards a more benign view of public debts.[264]

The Liberal Party, as distinguished from the Conservative Party, included a number of monetary reformers, principally from Western Canada. One of these monetary reformers was W.A. Tucker (Rosthern). Tucker, an MP from a debtor region, felt the Government was not making adequate use of the banking system to increase credit and thereby reduce the "tremendous drain of interest which today is ruining society."[265] Observing the steady growth of public debt and its heavy attendent service charges, Tucker proposed the expansion of the currency by some $700 million to be backed by a 20 per cent gold reserve.[266] Here Tucker obviously agreed with the Social Credit inflation proposals which called for a reckless increase in legal tender which would magically lift the burden of debt from the population.[267]

Gerry McGeer, was another monetary reformer who railed against the money power for years and was ultimately given his just reward, a Senate seat, in 1945. The colourful, former mayor of Vancouver shared with members of the Social Credit party a distaste for the "debt creating system".

> We borrowed to build roads, to build railways, and to build bridges across the St. Lawrence believing that posterity was to carry the load. But, unfortunately, for this generation we have caught up with posterity, and the load which we thought posterity was going to bear we cannot carry ourselves. A debt claim system, under which men interested in interest bearing bonds control the issue of currency and credit, is not a safe system. If we are going to have progress financed and democracy maintained we must do what has been done with the post office, administer it as a public utility largely free from partisan influence.[268]

McGeer, like other monetary reformers, preferred to emphasize the liability side of

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[264]See J.W. Pickersgill, *The Mackenzie King Record, Volume I, 1939-1944,* (Toronto: 1960), p. 28. "King did not take an active role in financial and economic policy.... He had a great deal of confidence in Ralston and Clark."
[265]House of Commons, *Debates,* 18th Parliament, 1st Session, 26 February 1936, p. 553.
[266]House of Commons, *Debates,* 18th Parliament, 3rd Session, 14 March 1938, pp. 1296-1297.
[267]See also House of Commons, *Debates,* 18th Parliament, 4th Session, 16 February 1939, p. 1015.
[268]House of Commons, *Debates,* 18th Parliament, 1st Session, 8 June 1936, p. 3499.

borrowing and the yoke of inherited debt while rejecting the excessively theoretical argument of some academics who *assumed* a growing national income would take care of the debt. McGeer's solution lay in the manufacture and issue of silver coinage which would be used to supplement the Bank of Canada's notes and subsidiary coin.[269] Needless to say, when the Liberals returned to power in 1935, both McGeer and Tucker remained safely outside the Cabinet Committee room.

In opposition, King soon realized the significance of a publicly owned central bank as an election issue, particularly in the West. While the Labour Party, the Progressives and the newly formed C.C.F. were demanding radical changes in the structure of Canada's financial system, King was able to occupy the middle ground claiming that the C.C.F. proposals were a sham. Fortunately for King, Bennett's decision to set up a privately owned central bank opened up the Tories to the charge that Parliament and the people must regain control of a lost prerogative. Even the usually cautious Leader of the Official Opposition championed this movement to regain Parliament's lost powers. King framed his attack by positing a potential conflict between the directors of the privately owned bank and the sponsor government. King stated:

> In the world of finance, the money power as it is termed, is of course the all important factor that many people believe is greater than the power of the government itself. What I am anxious to be perfectly sure of is that the government of the day, in parting with some of the ownership of the money power to a privately owned and controlled institution which will be allied to all of the banks of the country and through them to all the financial interests of the country, is not bringing about a situation in which at some critical time should a question arise as between the financial interests in a large way, the two might clash, and the government find itself powerless, at least until parliament should be called together, to deal with the situation. In the meantime, in such a case, the financial interests may have had their way in furthering their interests, albeit their action might be against the public interest.[270]

Rhetoric aside, King rightly believed that the Dominion's fiscal or social policies could clash with monetary policies favoured by finance. King's conceptualization of the conflict based

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[269] The Liberal member from Vancouver Centre, also shared with the Presidential campaign of Progressive-Democrat candidate William Jennings Bryan the wish for the unlimited coinage of silver (bimetallism) as against the monometallism of the gold standard. In 1873 the free coinage of silver was discontinued by an Act of Congress and in 1890, the Sherman Law authorized the settlement of all contracts in gold specie. What the movement sought to achieve was a return to the pre-1873 era with the implementation of a bimetallic currency regime in which both silver and gold would be accepted in payment of debts. The campaign was based in the rural areas in the west and southern United States which had been hard hit by a depression which carried on from the late 1870s to the early 1890s.

[270] House of Commons, *Debates*, 17th Parliament, 5th Session, 21 June 1934, p. 4193.

on "interests", while vague, did show that he conceived of a narrow financial community pitted at times against a majority of individuals whose financial resources and economic objectives might differ. King's pre-election declaration that "credit is a public matter, not of interest to banks only, but of direct concern to the average citizen,"[271] deliberately appealed to the more radical elements in the debtor regions[272] while being sufficiently vague so as not to alarm the Liberals corporate contributors.

Furthermore, King manipulated the widespread phobia of the Bank of England in certain quarters of the population to gain voter support. During final reading of the Bank of Canada bill, Mackenzie King claimed "the present legislation establishing the Bank of Canada, is a definite step in the establishment of an imperial policy of finance, under which the financial destiny of Canada is placed under persons independent of parliament, who can maintain, through the Bank of England and other central banks of empire nations, a definite and positive control of empire, currency, credit and trade."[273] Thus, the Liberal leader by railing against the "money power" and Montagu Norman was certain of success in the West (outside Alberta) and was able to cleverly undermine the C.C.F. strength by warning of the threat of bolshevism.

Yet back in power, the Liberals' fiscal policy remained orthodox. The Government's Finance Minister, Charles Dunning, oriented fiscal policy towards balancing the budget. Indeed, Dunning, the quintessential Finance Minister, often chastized parliamentarians as being culpable for the current growth of deficits and debts when

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[271]House of Commons, *Debates*, 17th Parliament, 4th Session, 27 February 1933, p. 2511.
[272]See H. Blair Neatby, *The Politics of Chaos*, (Toronto: 1972), p. 69.
[273]House of Commons, *Debates*, 17th Parliament, 5th Session, 27 June 1934, p. 4365. From *The Financial Post* these comments: "The Bank of England crowd have worked persistently to establish in the Empire a ring of central banking organizations which would be dominated by a keystone institution in London, thus strengthening the grip of a small London group on Empire finance, and making banks in the various Dominions pawns of a gigantic scheme of Imperial control through finance...... Already their agents have been active in Ottawa, attempting to shape the foundation on which our new banking legislation will be erected." "The Nation's Business", 21 October 1934. Perhaps the strangest exposition of the theory came from Liberal Senator J.P.B. Casgrain who argued that the Bank of England was controlled by Jewish bankers. Senate, *Debates*, 17th Parliament, 5th Session, 28 June 1934, pp. 602. "The purpose of Mr. Montagu Norman is to try to get the banks in all the Dominions and colonies under the control of the Bank of England. He has good reason for doing that. I do not know whether everybody is aware that the Bank of England is controlled by the London traders. And who are these traders? They are mainly very largely people of German and Jewish origin in many cases German Jews. They are the masters of Mr. Montagu Norman, and if he did not do what he was told he would not keep his place very long." This indicates that the kind of wild speculation about conspiracies centered at the Bank of England were not only held by the Social Credit advocates.

demanding larger expenditures for their constituencies.[274] And during his Budget Speech of June 1938, Dunning uncharacteristically defended his predecessor's steadfastness (Bennett) in pursuing the orthodox course of refunding in spite of urgings to follow Australia's compulsory refunding scheme.

A shift from the traditional, burden approach to the public debt may be found in the first war budget brought down by J.L. Ilsley in September 1939. Ilsley first distinguished "real costs" of the war as the goods and services which have to be sacrificed out of current production to meet the needs of war– the benign school of thought.[275] These displacement costs could, in Ilsley's view, be lessened by a rise in national output. In October 1940, King's diary records a discussion in Cabinet on the financial situation with Clark present. On this occasion, Clark was reassuring in his view that a rapidly expanding national income would be able to service the mounting government expenditures and mounting public debt.[276]

During the war, the main issue facing Cabinet was to properly balance the need to pay-as-you-go with heavy taxes against the dangers of inflationary bank financing and the creation of a heavy future interest burden. As discussed in Chapter V, both Clark and Towers pressed for a policy of heavy taxation which would reduce unnecessary consumption and take some pressure off capital markets. King, when commenting on Ilsley's April 1941 budget noted

> I thought Ilsley's Budget had placed almost too heavy a burden on the people. It must be remembered that a number of them had never seen Europe and were having a hard struggle here. *We would have to be careful not to crush the spirit in any way, or affect the morale.*[277]

However, by 1942, the whole complexion of the war effort had changed and circumstances demanded even greater sacrifices in both human and financial terms. As the C.C.F. and the Social Credit called for interest free loans from the wealthy and financial institutions, that is, conscription of wealth, armed services conscription raised its ugly head. In February 1942, King argued before caucus the case for conscription of wealth if "human life" was to be conscripted. King drew the analogy between voluntary

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[274] House of Commons, *Debates*, 18th Parliament, 3rd Session, 28 April 1938, p. 2339.
[275] House of Commons, *Debates*, 18th Parliament, 5th Session, 12 September 1939, p. 137.
[276] Pickersgill, 1960, p. 155.
[277] Pickersgill, 1960, p. 220. (emphasis added).

subscriptions for service and the voluntary purchase of a bond. The Prime Minister believed if armed services conscription would be required, so too was wealth conscription necessary and politically defensible.[278]

Liberal sensitivity to the public mood as captured by the C.C.F.'s war-time call for punitive corporate taxes and conscription of wealth brought forth measures to tax wealth and income. What Reg Whitaker has called the Liberals' "greater sensitivity to the need for public mystification"[279] was evident in Ilsley's 1942 budget measure for a "refundable excess profits tax." With one hand, the Government dipped its hands into corporate treasuries and with the other hand reimbursed 20 per cent of the tax after the war. The compromise of low interest loans imposed on the banks in the form of deposit certificates is another example of a compromise response to the C.C.F. and Social Credit demands for low or no-interest loans from financial institutions and wealthy Canadians.

By late 1943, the Liberal Government turned its attention towards domestic matters, in particular reconstruction and the party's prospects for re-election. In August of that year, the Ontario C.C.F. had come within four seats of controlling Canada's largest provincial government. In October, King "spoke of the need for Ilsley to show reduction in the Budget instead of increase at the session immediately before the election." "Fuller taxation," King recorded, "would mean we might as well hand over the Government in its entirety to the C.C.F."[280] In the Throne Speech delivered in January 1944, some of the recommendations based on the Marsh Report and from the Economic Advisory Committee were brough forward. Included in the proposed legislative package designed to spike the guns of the C.C.F. were public employment projects, universal old age pensions, and family allowances. The estimated one billion dollar package was labelled by Walter Gordon at the time as "pie in the sky".[281]

In the following months, King continued to demonstrate an almost pathological preoccupation with the threat from the political left. These fears were amplified when in June of 1944, the first social democratic government in North America was elected by a landslide in Saskatchewan. King wanted to be sure that Ilsley's upcoming budget would be politically popular and would include the raising of tax exemptions and the release of

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[278] *Ibid*, p. 351.
[279] "Images of the State in Canada," in Panitch (ed.), 1977, p. 58.
[280] *Ibid*, p. 598.
[281] See J.L. Granatstein, 1975, pp. 256-261.

complusory savings legislated in the 1941 budget. Ilsley initially threatened to resign on learning of King's request, citing the need to "stay the course". At the end of June, Towers and Clark attended a Cabinet meeting on the budget. The Prime Minister, while conceding that the ideal course would be a continued high level of taxation, urged his advisers to see the whole picture. Without these small concessions, stated King, the Liberals would be swept out of power by "a C.C.F. administration, which would soon clean up the whole financial position" leaving Clark and Towers to fill in for themselves the ominous implications.[282] This argument evidently impressed Clark and Towers and resulted in the release of part of the compulsory savings.

This particular budget also revealed the final conversion of the Government and its officials to a benign theory of public debt. J.L. Ilsley provided the following reasons why mounting interest costs would not choke off post-war economic reconstruction:

1. "In paying interest on its national debt, the nation is *simply making a transfer of income amongst its own people*, and in many cases the same people are paying taxes and collecting interest."
2. A "steeply progressive" tax regime would place the heaviest tax burden to meet these interest expenses on the holders of Dominion bonds.
3. Foreign debts of the Dominion were insignificant; therefore the leakage of interest and principal from the Canadian economy was minimal.
4. A substantial proportion of the debt was incurred in "the purchase of revenue bearing assets which carry themselves and do not constitute an extra burden."[283]

Ilsley's speech may be interpreted as a sedative concocted to ease the anxiety of bondholders and taxpayers who, knowing the end of the war was fast approaching, were asking for assurances about the financial future and the value of their debtholdings. The assurances given by Ilsley were mildly misleading. The most blatant stretching of the truth was the statement that of the approximately $13 billion borrowed, a substantial proportion was in the form of productive assets. In fact, as everyone knows the "productive assets" used in war are frequently destroyed or do not find a place in the productive stream of capitalism. The real productive assets owned by the Government in the form of C.D. Howe's industrial empire were auctioned off shortly after the war at well below market value meaning the taxpayers were subsidizing corporations which took over the plant and

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[282] Pickersgill and Forster, 1968, p. 31.
[283] House of Commons, *Debates*, 19th Parliament, 5th Session, 11 July 1944, p. 4717. (emphasis added)

equipment. Another flaw in Ilsley's argument were the claims respecting a broadly dispersed public debt. Although it is true that the final Victory Loans saw over three million Canadians participating, many of these sales were made on credit and the bonds were sold soon after.[284] In short, the rosy picture painted by the Minister was not entirely consistent with the facts and too many uncertainties including the course of interest rates and the health of the world economy, made this statement a public relations exercise and not a theoretically sound statement on principles of public debt.

Safely re-elected in June of 1945, the Finance Minister resisted any new measures designed to give taxpayers' relief. Retirement of the debt through budget surpluses was the name of the game. The attitude of the Cabinet towards borrowing and taxation became largely dependent on the election cycle.[285] In 1946, while King did not desire new tax increases, he nevertheless cautioned against the approval of new social measures added on top of the recent inititaives. Yet, the repeatedly large, unanticipated surpluses proved embarrassing for King who believed that the present generation should not be forced to carry the whole burden of the war. In discussing the 1948 budget, D.C. Abbott, the new Finance Minister thought it best "to reserve this for next year [tax cuts], make a good showing next year, better than cutting things into two- one half this time and the other, next year."[286] This provides further support for the suspicions of the Conservative spokesmen who believed the Liberals were manipulating the national finances to gain the maximum political advantage.

Apart from Social Credit's perennial scheme to retire the national debt by issuing debt and interest free national money, no political party, including the governing party, offered a *systematic, comprehensive policy* for debt retirement. To be sure, the "White Paper" on Employment tabled by C.D. Howe in April 1945 provided a general framework

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[284]In fact, Ilsley stressed the importance of the general public being able to hold on to their bonds when reporting to the House on the Fourth Victory Loan campaign. House of Commons, *Debates*, 19th Parliament, 4th Session, 28 June 1943, p. 4074. Figures prepared by the National War Finance Committee show that 25 to 30 per cent of all "cash sales" to individuals were paid for by bank credit and that 6,000 "special name" subscribers (wealthy persons and corporations) accounted for well over 50 per cent of total war bond sales. *Statistics and Information*, 1945.

[285] Stanley Knowles, commenting on Liberal debt reduction, noted debt reduction and general elections took place at quite different times. House of Commons, *Debates*, 21st Parliament, 6th Session, 10 March 1952, p. 255. The Winnipeg M.P. observed that debt reduction was ardently championed immediately after a general election yet immediately prior to an election no Finance Minister was heard advocating the merits of this cause.

[286]Pickersgill and Forster, 1970, pp. 293-294.

with respect to surplus and deficit budgeting. Still, an ad hoc approach was taken and the Dominion, through its Securities Investment Account, soon found itself a substantial purchaser of the debt.[287] While no explicit policy was ever enunciated, a coherent pattern emerged. This pattern of budget making consistently under-estimated the budget surplus. Abbott and his officials consciously followed this strategy knowing full-well that the publication of larger surplus projections would set Liberal backbenchers howling for tax cuts which the Minister, his officials, and the central bank did not support.[288] This approach resulted in a fall in the national debt from $18.96 billion at March 31, 1946 to $15.585 billion at the end of March, 1949.[289]

Liberal policy towards foreign debt was generally in sympathy with the Tories' desire to see the foreign component of the national debt reduced. However, as the following exchange between Charles Dunning and H.H. Stevens illustrates, there were many different factors to be considered on the matter of foreign held debts. During debate on a loan authorization, Stevens questioned the Minister on the advisability of continued U.S. borrowings.[290] Stevens argued that a foreign borrowing policy should be predicated on the balance of trade. He contended that heavy indebtedness to the United States, a nation with which Canada had normally run up a large balance of payments deficit, was mistaken since Canada's trade deficit did not allow the debtor nation to repatriate debts by running surpluses on goods and services. Borrowing on the London exchange, on the other hand, was acceptable inasmuch as Canada's trade surplus allowed the country to comfortably meet its sterling obligations.[291]

Dunning, in response, pointed to Canada's large repatriation of foreign debts during a decade of depression characterized by a positive balance of payments. While regarding this development as an "improvement", the Minister queried the "tendency (is) to pick up an isolated fact, which appears by its nature to support the particular panacea which one may

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[287] See Budget Speech of Finance Minister D.C. Abbott, House of Commons, *Debates*, 20th Parliament, 4th Session, 18 May 1948, p. 4058.
[288] See Robert Bothwell, Ian Drummond, and John English, *Canada Since 1945: Power, Politics, and Provincialism*, (Toronto: 1981), p. 132.
[289] *Public Accounts of Canada*, (Ottawa: 1946-1949). It should be noted that almost one-half of this redemption was effected by the Ninth Victory Loan which raised over $2 billion. Most of these funds were not required and sat as cash in the Consolidated Revenue Fund. Macdonnell was critical of the government's budgetary policy suspecting it had been withholding tax reductions for electoral purposes. House of Commons, *Debates*, 20th Parliament, 5th Session, 4 February 1949, pp. 262-263.
[290] House of Commons, *Debates*, 18th Parliament, 4th Session, February 1939, p. 835.
[291] *Ibid*, March 1939, pp. 1007-1008.

have in mind, and to base an argument upon it."[292] For Dunning, the complex interdependence of foreign and domestic capital, exchange rate fluctuations, and monetary policies made it difficult to devise a simple, straightforward financial recipe in isolation from the rest of the world.[293]

In the early part of the war, Ilsley and the Government were preoccupied with financing the huge balance of payments deficit with the United States. This sensitivity to foreign indebtedness was illustrated in Ilsley's comment "We ought to be in a position to pay for what we get." A strict programme of minimizing indebtedness to the Americans was actively pursued during the war.[294] The Minister's position also appeared to reflect some sympathy to sentiments expressed by Stevens during the last Parliament, that is, capital movements should bear some relationship to patterns of trade.

After the war, the question of foreign borrowing became solely a matter of dealing with the exchange value of the Canadian dollar and is therefore not of direct concern. During the summer of 1950 a large inflow of capital of unprecedented proportions began. "This inflow of funds," Douglas Abbott stated paternalistically, "this tribute by New York to the essential soundness of the Canadian economy and its prospects, was rather sudden and not a little embarrassing."[295] Despite the central bank's action to "sterilize" the dollar inflow by selling government securities from its portfolio

> After careful review of all the relevant factors, and after consultation with the international monetary fund, we came to the conclusion that the wise policy to follow was to withdraw the official rates on the United States dollar and allow the exchange rate to find its appropriate level in response to the normal supply and demand forces operating in the market from time to time.[296]

Thus, the Canadian Government had moved 180 degrees from its previous policy of a pegged rate, an administered rate and devaluing if necessary, but not necessarily

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[292] *Ibid*, p. 1006.

[293] In retrospect, Stevens' thesis tying indebtedness to a surplus in trade appears, at least on the surface, to be well founded. The experience during the decade leading up to depression in which the United States did not allow her debtors to penetrate the U.S. market to earn dollars to finance their debts seems to justify this view. Canada's continuing failure to deal effectively with her U.S. trade deficit has been postponed by increasing her reliance on short and long-term capital flows from the United States.

[294] House of Commons, *Debates,* 19th Parliament, 3rd Session, 8 June 1942, p. 3137. Prior to the Hyde Park agreement in April 1941, New York financing was strictly confined to the refunding of debts under the *Neutrality Act*. Towers himself was not too keen on seeing Canada becoming heavily indebted to the Americans. See Towers Memoranda, No. 370, 6 December 1940, "Conversation with Clark, Macfarlane, Johnson, Gordon," *Bank of Canada Archives*.

[295] House of Commons, *Debates*, 21st Parliament, 4th Session, 10 April 1951, p. 1800.

[296] *Ibid*.

devaluation. When it became in Canada's perceived interest, or more particularly in the interest of the Minister and the Government, to follow the market, it did so. That Autumn, the Canadian dollar rose steadily trading eventually at a five to six per cent premium over the U.S. dollar allowing speculators a handsome profit.

Summary

Based on the limited evidence available, the Liberal Party took a more flexible and pragmatic stance when dealing with debt management. This is demonstrated by the gradual adoption of a benign view of the public debt. And yet, while avowedly adopting Keynesian counter-cyclical budgeting in 1945, budget policy remained heavily influenced by political considerations i.e. proximity to the election date. On the broader questions of credit and banking, the formulation of policy stood in sharp contrast to the policy of the party in government. The Liberal's pragmaticism of the centre as described by Horowitz[297] is most evident in King's remonstration of Clark and Towers that unless "finance" was willing to make compromises, the socialists would come to power. As shown below, a similar argument was put by Ilsley to bankers in the summer of 1942.

The Co-operative Commonwealth Federation

The orientation of the C.C.F. to public debt can best be understood in the context of their broader political programme. The Regina Manifesto represented an attempt by intellectuals, labour and the farm community to draft a blueprint for social reconstruction. The rhetoric of nationalization was founded on the need to put industry and finance at the service of the people. A radically redesigned tax system was advocated to reduce the wide inequalities of wealth and income caused by the capitalist system. These overall goals were to be achieved through a type of social planning undertaken by the central government. Without the nationalization of finance including the banks, trust companies and life insurance firms, the movement towards a social democratic state would likely falter.

The C.C.F. therefore addressed the question of the *distribution* of the debt in the context of the broader issue of the distribution of wealth and income. To Reverend Woodsworth (Winnipeg North Centre), the economic crisis required drastic action

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[297]His *Canadian Labour in Politics*, (Toronto: 1968), pp. 29–44.

including a scaling down of debts. This was justified as "the people who to-day are holding bonds and mortgages of various kinds should receive interest and final repayment *on the basis of the value of the dollar at the time those debts are contracted.*"[298] Accordingly, deflation should affect both the incomes of bondholders and wage earners equally.

During war-time, the new C.C.F. leader M.J. Coldwell warned of the possibility that during an "inevitable post-war depression", the small investors' bonds would be sold at a discount to plutocrats.[299] The C.C.F. member from Melfort, Saskatchewan, P.E. Wright argued that the published bond campaign data indicated a small group of persons and corporations were gaining control of the national debt. Wright feared that this ownership would give a minority command over the services of the majority, non-bondholding public who, would "pay tribute not only for one generation but for generation after generation."[300] Were the people going to tolerate a small minority of coupon clippers demanding the service of men and women "who fought to make those coupons worth the paper they are written on?" asked Wright.[301]

While the C.C.F. did not share the Social Credit's religious aversion to interest, C.C.F. members representing constituencies with large debtor populations fought strongly for a lowering of interest rates. The Labour member from Winnipeg North, A.A. Heaps attacked the Government for selling bonds at 5.25 per cent which "meant the adding of millions upon millions of dollars to public debts in this dominion; because the moment the federal government issued bonds at 5 1/4 per cent our provincial government had to pay 6 and 6 1/2 per cent on money it wished to borrow."[302] Thus, the inability of the Dominion to control the rate of interest, which it supposedly was constitutionally entrusted to do, affected unfavourably the borrowing costs of other debtors. Heaps' statement revealed a correct understanding of the trend-setting role played by the prices and yields of gilt-edged Canada bonds.[303]

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[298]House of Commons, *Debates*, 17th Parliament, 2nd Session, 17 June 1931, p. 2752. (emphasis added)
[299]House of Commons, *Debates*, 19th Parliament, 1st Session, 29 may 1940, p. 355.
[300]House of Commons, *Debates*, 19th Parliament, 4th Session, 12 March 1943, p. 1223 and House of Commons, *Debates*, 19th Parliament, 3rd Session, 3 February 1942, p. 268.
[301]*Ibid*, 3 February 1942, p. 268.
[302]House of Commons, *Debates*, 17th Parliament, 3rd Session, 11 April 1932, p. 1916.
[303] A novel suggestion concerning a *controlled* downward orchestration of interest rates was offered by M.N. Campbell (Progressive, Mackenzie). Campbell proposed lowering the maximum rate charged borrowers, thus forcing the banks in turn to "reimburse

The image of a mounting burden on the backs of the little people was painted by J.S. Woodsworth in a speech during 1933.

> Debts have increased even faster than ordinary expenditures, the per capita increase being 147 per cent of the rate of increase in ordinary expenditures. The expenditures in debt service during 1930–31, the last figures given by Mr. Evans, amount to $225,603,554, or one quarter of the entire expenditures. It is an appalling situation. *Governments have become vast debt collecting agencies; we exist very largely in order to gather from the little people all over the country huge sums, of which then we turn over a very considerable proportion in the form of interest.*[304]

Woodsworth's concerns were echoed in a later Parliament by C.G. McNeil (Vancouver North) who noted that interest alone then accounted for 36 per cent of governmental expenditures. This "tribute", payable to a small elite was maintained through a policy of raising taxes and cutting government services.[305] MacNeil, identifying the heavy burden of interest paid which contributed to the already high level of taxation, proposed a special debt retirement fund. Fearing the reduction of social services as debts continued to multiply, MacNeil advanced the idea that the principal of the debt be paid off quickly thus permitting a lowering of taxes and the maintenance or increase of social services.[306]

During the war, Coldwell was the most prominent advocate of very low rates of interest and the "conscription of capital". Coldwell believed in equality of sacrifice and was disturbed by the thought that vast accumulations of personal and corporate wealth might be amassed over war-time.[307] In February 1941 and again in January 1942, Coldwell

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303(cont'd)themselves by reducing the rate of interest paid on deposits." By lowering these savings rates to one and a half or two per cent, depositors would possibly place their funds at the disposal of the Dominion and the provincial governments by purchasing bonds. (House of Commons, *Debates*, 17th Parliament, 3rd Session, 18 April 1932, p. 2135.)

304 House of Commons, *Debates*, 17th Parliament, 4th Session, 5 April 1933, p. 3740. (emphasis added) Woodsworth was referring to the debts of all governments. E.J. Garland (U.F.A. Bow River) expressed agreement with Woodsworth, questioning the Government's policy of borrowing indefinitely without ever repaying a nickel in principal. (House of Commons, *Debates*, 17th Parliament, 5th Session, 19 March 1934, p. 1620.) William Irvine was even more categorical in his demand for a general reduction of debts, a reduction which he imagined would benefit creditors as much as debtors "for with their power of controlling money they can make more money in a year under prosperity than they are going to lose by the cut in debts which will have to be made." (House of Commons, *Debates*, 17th Parliament, 5th Session, 19 March 1934, p. 1605.) In Irvine's view, debt reduction was legitimate, necessary, and inevitable in restoring the balance between debtors and creditors in the wake of the disastrous fall of commodity prices. (*Ibid*, p. 1604.)

305 House of Commons, *Debates*, 18th Parliament, 1st Session, 12 May 1936, p. 2733 and House of Commons, *Debates*, 18th Parliament, 2nd Session, 15 February 1937, p. 880.

306 House of Commons, *Debates*, 18th Parliament, 1st Session, 12 May 1936, p. 2733. Professor Pigou recommended a massive debt retirement scheme for England after World War I.

307 House of Commons, *Debates*, 19th Parliament, 1st Session, 29 May 1940, p. 355.

moved resolutions calling for *interest-free loans* on the accumulated wealth of individuals and corporations.[308] These proposals went further than Keynes' compulsory savings plan on which a low rate of interest would be paid by the state. These demands for low cost financing may have influenced the Government into the sale of low-cost securities to the banks (deposit certificates) and introduction of a "refundable tax" plan in 1942.

After the war, the C.C.F. remained supportive of the Government's low interest rate policy. Coldwell ridiculed the Tory Finance critic's belief in the necessity of allowing interest rates to rise with the market (discussed above). The C.C.F. leader scoffed at Macdonnell's recommendation for it would have meant a sharp upward movement in the cost of financing new housing. He also went on to stress the importance of maintaining low interest rates in light of the collosal interest charges faced in the post-war period by the Government as a debtor.[309]

C.C.F. policy on the use of the central bank as an economic policy instrument was articulated by M.J. Coldwell before the Commons' Committee on Banking and Commerce in May 1939.[310] Coldwell, in his presentation dismissed Social Credit theory on two fronts. First, the issue of huge sums of paper money to "repay" the national debt would clog the financial system with those holding securities not redeemed benefitting from the subsequent rise in bond prices.[311] Secondly, an injection of three quarters of a billion dollars into the money supply would undoubtedly have severe inflationary effects.[312] It was the C.C.F.'s contention that *moderate reflation* was required by creating new money through the Bank of Canada to finance *government public works* which would help those out-of-work labourers the most.[313] Coldwell's testimony before the committee also revealed that the party was well aware of the distributional inequities arising from the inflationary process.[314] In general, the C.C.F.'s strategy involved the use of the central bank's note issue privilege to finance public works, thereby stimulating a rise in income,

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[308]House of Commons, *Debates*, 19th Parliament, 2nd Session, 19 February 1941, pp. 841-843 and House of Commons, *Debates*, 19th Parliament, 3rd Session, 26 January 1942, p. 57.
[309]House of Commons, *Debates*, 20th Parliament, 3rd Session 6 May, 1947, p. 2806.
[310]*Minutes of the Proceedings and Evidence of the House of Commons Standing Committee on Banking and Commerce* , No. 16, 18th Parliament, 4th Session, Wednesday, 10 May 1939.
[311]*Ibid*, p. 518. However, inflationary fears might very well depress bond prices.
[312]*Ibid*, p. 519.
[313]*Ibid*, pp. 519-520.
[314]*Ibid*, p. 523.

increasing taxes and reducing the burden of relief payments– in short, a bottom–up economic prescription.

This policy of moderate reflation was consistent with the actual policy of the Bank of Canada which presided over a modest ten per cent growth in the money supply between December 1935 and December 1938.[315] This recommendation was framed along similar lines to a $39 million issue of Dominion notes in 1934 to finance public works. The C.C.F.'s platform therefore can only be termed radical in the sense of its calling for the complete nationalization of the financial system including banks, trust and insurance companies and for the creation of a National Finance Commission, an umbrella organization with powers to regulate the volume and direction of credit.[316]

The C.C.F. while sharing Social Credit concerns about the distribution of the public debt, the need to place "finance" under the direct control of the people or the people's representatives, and the requirement for lower rates of interest, disagreed on the extent of a fiduciary note issue ("debt free money"). The C.C.F. believed that banks and finance should be subordinated to the goals of society and a nationalized financial system would be instrumental in achieving full employment and a more equitable distribution of wealth and incomes. The C.C.F., like the Social Credit, did not express a clear position with respect to public debts held by foreign residents.

The Social Credit Party

In analyzing these debates, one is struck by the oft–expressed view of this vocal parliamentary group stressing the dangers and perniciousness of private and public debts. Many members, witnessing firsthand the misery of their constituents ruined by foreclosure, naturally regarded debt and the creditor in a negative light. It was for this reason that several M.P.s were quite shocked to learn about double–entry book–keeping which revealed that national debts were offset by national assets– government debt in the hands of the bondholders.[317]

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[315]Evidence placed on record by Governor G.F. Towers, *Minutes of the Proceedings and Evidence of the House of Commons Standing Committee on Banking and Commerce* , 18th Parliament, 5th Session, No. 8, Friday, 28 April 1939, p. 205.

[316]In July 1983, the C.C.F.'s successor, the New Democratic Party on the fiftieth anniversary of the Regina Manifesto passed a resolution calling for the nationalization of *one* of Canada's "Big Five" banks. It is difficult at this time to say whether this move signals a move to the left by the social democrats.

[317]*Minutes of the Proceedings and Evidence of the House of Commons Standing*

Such a view was so much at odds with the monetary and economic gospel of certain members that the Governor's celebrated comments were taken as an endorsement of a growing national debt-- the Hamiltonian view. The views of the Social Crediters may be seen as similar to those of Adam Smith who opposed increasing indebtedness as a prelude to state insolvency. Where Social Credit and Smith parted company was over the control of credit and currency. Social Credit was prepared to control and direct the flow of currency and credit, a view unacceptable to the father of *laissez-faire*. Given the dominance of the Social Credit M.P.s in the debates on the public debt, it is necessary to digress for a moment to sketch the highlights of Social Credit theory.

Digression on Social Credit Theory

The Scottish engineer, Clifford Hugh Douglas, the father of Social Credit began his economic investigations by attempting to explain the causes of underconsumption.[318] According to Douglas this underconsumption was the result of a deficiency in purchasing power and this deficiency arose because payments to individuals in the form of salaries, wages, and dividends (for consumption) were always less than payments to organizations engaged in production (the famous "A+B Theorem").[319] Accordingly, only loans or export credits were available to remedy this perceived deficiency.[320] And as industrialization progressed, the productive sector grew at the expense of the labour-consumer group which enhanced the significance of credit which displaced wages and salaries as a form of necessary purchasing power.[321] This then is the basic economic analysis associated with Major Douglas; that the growing hegemony of finance means that the control of credit is critical to the development of industrial economies. As William Aberhart gleaned from Douglas' analysis, credit was the lifeblood of the economic system. We now turn to the political implications of the theory.

After ascribing to credit the role of ameliorating this chronic shortage of consumption or purchasing power,[322]

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[317](cont'd)*Committee on Banking and Commerce* , No. 3, 19th Parliament, 5th Session, Tuesday, 2 May 1939, pp. 234-235. Testimony of Governor Graham Ford Towers.
[318]For an evaluation of the underconsumptionist intellectual tradition in England see John L. Finlay, *Social Credit: The English Origins*, (Montreal and London: 1972), Chapter 2.
[319]C.H. Douglas, *The Monopoly of Credit*, (London: 1933), pp. 30-37.
[320]*The Control and Distribution of Production*, (London: 1922), p. 23.
[321]*Ibid*, p. 24.
[322]"The only object of production," wrote Douglas "is consumption, whether that takes the material form in which the word is commonly understood, or whether we extend its meaning to include the artistic gratification which is to be obtained from production

Douglas asked how the allocation of credit is determined at present. In England, as in most places, this power resided in banks– "so–called private institutions which administer this collective credit for their own ends, and those ends are by no means similar to the ends of the community of individuals from whom the credit takes its rise."[323]

How, then, was this control exercised? Credit was created by the stroke of a banker's fountain pen. Douglas cited Reginald McKenna, onetime Chairman of the Midland Bank had once remarked "every bank loan and every purchase of securities creates a deposit, and withdrawal of every bank loan, and the sale of securities by a bank, destroys a deposit."[324] This somewhat mystical capacity was of no small consequence when employed in connection with state finance which permitted the banks to advance credits at interest to the state in exchange for government paper. In exchange for creating a government deposit, in essence an overdraft privilege, the banks could possess vast sums of government debt *without* borrowing the funds from the legendary small depositor. It was the *monopolization* of state debts held by banks which represented the ultimate triumph of the financiers over the people.[325]

The inner logic of this world view held that a political struggle be waged by the people to overthrow the ubiquitous money power. It was apparent this struggle meant a total restructuring ,of central banking institutions also for they were instrumental in preventing the elected representatives from gaining access to this credit creating mechanism.[326] In practical terms, the political objective was to wrest the control of credit from the banking system, including the central bank and to return it to the elected representatives of the people, where it properly belonged.

Douglas' most specific recommendations for solving the underconsumption crisis was the creation of additional purchasing power through a price discount scheme or the issue of legal tender money. The "financial deficiency" to the producer would be recouped by "issuing additional sufficient purchasing power which is not passed through the costing system and therefore does not increase prices, in the form of a National

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322(cont'd)carried out under suitable conditions." *Social Credit,* (London: 1934), p. 124.
323Douglas, 1922, p. 28.
324Douglas, 1933, p. 15.
325*Ibid*,p. 22 and Douglas, 1934, pp. 160–177.
326C.H. Douglas, *The Alberta Experiment: An Interim Survey,* (London: 1937), pp. 58, 109.

Dividend, or more probably by both of these methods together."[327] The notion of deficient purchasing power perpetuated through the banking system was exceptionally appealing to farmers, debtors, and retailers experiencing "poverty in the midst of plenty."[328] Particularly persuasive was his analysis of banking which created credit from nothing "at the stroke of a pen." To his Western Canadian adherents, this insight opened up a brave new world through the mastery of credit management and by the "scientific" balancing of production with purchasing power.

Though public debts *per se* did not figure prominently in Douglas' writings, it is fair to say that he was sensitive to the banks' major holdings of government securities.[329] The dangers associated with concentrated holdings of the state's debt could be overcome by the creation of what Social Crediters termed 'debt-free", "interest-free" money by and for the state and not by and for the banking system.

Interest Rates and the Burden of the Debt

Interest was to the Social Credit M.P. a most objectionable aspect of the money sytem which was, at its very roots, a system based on debts owed to banks. For Victor Quelch, debt-free, interest free money was legal tender, duly issued by a central bank "which could be taken out of circulation through taxation or through the price factor discount."[330] This "national money", founded upon the credit of the whole nation, would thereby rectify the alleged purchasing power deficiencies stemming from an archaic financial system. Instead of pledging posterity to pay for current consumption, Quelch advocated national money as a means to end this spiral of indebtedness.[331] This inter-generational transfer of costs through the existing price and money system, according to Quelch, was the result of interest associated with the production and manufacture of goods and services. Such proposals earned the well-deserved mirth of the Minister of Finance and many members of the Commons who labelled these recommendations "funny money" and "printing press" money. What the Social Crediters failed to realize was that individuals would not lend their money without the guarantee of a

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327 *Ibid*, p. 37.
328 See J.A. Irving's socio-psychological explanation of the Alberta Social Credit movement, "The Appeal of Social Credit," *Queen's Quarterly*, Volume 60, No. 2 (Summer 1953), pp. 146-160.
329 Douglas, 1934, p. 22.
330 House of Commons, *Debates*, 18th Parliament, 4th Session, 3 March 1939, p. 1519.
331 *Ibid*, p. 1520.

rate of return. This simple truth was equally applicable to holders of government bonds who, if they believed the government was acting irresponsibly by dictating a policy of massive note printing to the Bank of Canada, would not entrust their funds to the government or other borrowers without an adequate rate of return to safeguard against the possibility of inflation. Social Crediters nevertheless were correct in their reasoning that the printing of legal tender did not, of itself, lead to inflation. If the cash reserve ratio of the banks was increased this would prevent a large increase in bank credit under the fractional reserve system.

Among Social Credit members, the chief spokesmen on the subject of interest rates, usury and the burden of the debt were Joesph Needham (The Battlefords) and J.C. Landeryou (Calgary East). Needham and Landeryou pointed out that high interest rates when compounded over the years exceeded the Dominion's principal indebtedness.[332] Needham and his colleagues queried the need to pay interest on money borrowed, or "debt money" advocating the issue of "debt-free money" through the central bank.

> We heard a good deal this afternoon about loans and bonds. I say with all seriousness that if the credit of this country is good for a dollar bond, it is just as good for a dollar bill. If the credit of the country is good to float a loan of $100,000,000 through financial institutions, it should be just as good to float that loan by the government itself.[333]

J.C. Landeryou in recommending the creation of $600,000,000 in debt free money in place of bonded indebtedness took a slightly different tact than his confrere Needham. Landeryou envoked the writings and teachings of Martin Luther, Cato, Nehemiah, Schaff-Herzog,[334] Lincoln and Ezekiel on the evils of usury in justifying this inflationary proposal.[335]

During the war, Social Credit members were in the forefront in chiding the Government about its practice of paying interest on loans when Canada's youth was being slaughtered abroad. F.C. Casselman (Edmonton East) felt it was outrageous that money would not be forthcoming without the promise of interest. Casselman advanced one of the few sensible proposals of his party when he suggested that non-interest bearing

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[332]House of Commons, *Debates*, 18th Parliament, 1st Session, 26 February 1936, p. 559.
[333]*Ibid* 12 May 1936, p. 2722 and House of Commons, *Debates*, 18th Parliament, 2nd Session, 12 March 1937, p. 1752.
[334]A biblical scholar.
[335]House of Commons, *Debates*, 18th Parliament, 3rd Session, 29 March 1938, p. 1836.

bonds be *cashable on demand*, like savings certificates.[336] This proposal, unrealistic in one sense, that of not paying interest, however was a means of encouraging savings of the poor who might not be able to hold on to a bond for five or ten years. Casselman's colleague, Anthony Hlynka (Vegreville) also ridiculed those "patriots" who loaned money to the Dominion at 3.25 per cent. "Patriotosm," Hynkla imparted, "surely has a nobler meaning than that."[337] Victor Quelch avidly supported this non-interest platform warning that if debts continued to mount in concert with interest payments, post-war prosperity would be threatened. The member from Acadia urged the Dominion to issue more bank notes and less bonds thereby sparing the people of the huge burden of taxation after the war.[338] J.H. Blackmore, leader of the federal Social Credit caucus, stressed the post-war dangers inherent with refunding debt issued during the war. Forseeing a debt of $14 billion or more, Blackmore conjured up images of a group of men manipulating the interest rate to their own advantage.

> Suppose the rate of interest was increased to 3, 3 1/2, 4 or 4 1/2 per cent; imagine what would be the condition of the people with a contractual obligation of that kind, which is supposed to be as sacred as though it came from the sanctum sanctorum, the holy of all holies of all time.[339]

This view was also echoed by F.D. Shaw from Red Deer who reminded the Commons that the the growth of interest charges had, by 1943, exceeded pre-war Dominion revenues.[340] Shaw, in addressing the problem of post-war reconstruction referred to Viscount Bennett's speeches on fiscal probity and the heavy burden of the debt facing post-war Britain. The member from Red Deer emphasized the difficulty facing the Dominion from the heavy fixed interest charges which had to be met before any consideration could be given to social and economic reconstruction.

After the war, Solon Low, one-time Alberta Provincial Treasurer and leader of the Social Credit caucus, cited interest as the main source of the problem of the national debt. Pointing to President Truman's decision to cancel some $48 billion in foreign debts owed to the U.S. after the war, Low recommended wiping the slate clean for Canada. Low

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[336]House of Commons, *Debates*, 19th Parliament, 1st Session, 17 June 1940, p. 821.
[337]*Ibid*, 3 July 1940, p. 1305.
[338] House of Commons, *Debates*, 19th Parliament, 2nd Session, 19 February 1941, pp. 845-846 and 20 March 1941, p. 1720.
[339]House of Commons, *Debates*, 19th Parliament, 4th Session, 9 March 1943, p. 1090.
[340]*Ibid*, 1 March 1943, p. 805.

suggested that interest charges could be substantially reduced by the Government demanding that the banks "hand over" their Dominion bonds purchased with "created credit" and "the removal of the flaws of our monetary system."[341] This proposal was later amended to "convert bonded indebtedness to bank deposits",[342] another absurd proposal premised on the assumption that most state expenditures could easily be financed out of "national credit" regardless of constitutional and practical limits of taxation and monetary expansion. A similar proposal by Victor Quelch called for a "National Monetary Authority" to retire the debt through the issue of national credit.[343]

During the 21st Parliament, J.F. Shaw was highly critical of the *inflationary consequences* of borrowing from the banks.

> Substantially as a consequence of the pursuance of that inflationary policy of borrowing heavily from the banks, the boys came back and, with us, face a debt of $16 billion, as compared with the former three and a half billion, with interest charges of $442 million per year as compared with $129 million at the time the war broke out.[344]

Shaw also rehashed earlier criticisms of the policy of banks' creating credit for Victory bondholders. This took place, in Shaw's view, during a "condition of inflation resulting from too much money in circulation"[345]

Principal Constituting the Burden of the Debt

Social Credit fears of an insurmountable, burdensome, national debt were ironically given some support by bankers' statements predicting a lower standard of living after the war to pay off the debt.[346] C.E. Johnston (Bow River) spoke of the "staggering burden of debt" and for the necessity of using the Bank of Canada to free "production from the blighting control of finance."[347] This group believed that the initial monetary expansion sanctioned by the Government in the Autumn of 1939, should be continued. As J.H. Blackmore noted : "What consistent excuse can be given by this government for allowing

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[341]House of Commons, *Debates*, 20th Parliament, 2nd Session, 8 July 1946, p. 3238.
[342]House of Commons, *Debates*, 20th Parliament, 5th Session, 10 March 1949, p. 1335.
[343]House of Commons, *Debates*, 20th Parliament, 4th Session, 27 May 1948, p. 4459. These recommendations shared one thing in common with respected academic opinion: that debts held by the banking system were potentially inflationary and should be paid off as soon as possible.
[344]House of Commons, *Debates*, 21st Parliament, 4th Session, 13 February 1951, p. 344.
[345] *Ibid*, p. 343.
[346]N. Jaques, (Wetaskiwin), 31 May 1940, p. 373 and Victor Quelch, House of Commons, *Debates*, 19th Parliament, 4th Session, 25 February 1943, p. 713.
[347]House of Commons, *Debates*, 19th Parliament, 1st Session, 4 July 1940, p. 1344-1345.

that $200 million to be registered as a debt against the Canadian people?" Blackmore then went on to say, "if $200,000,000 can be created, the ordinary man on the street will say 'Why not have more than $200,000,000'?"[348] to hoots that this course was highly inflationary.

After the war, most of the rhetoric about debt as a heavy burden weighing down on the backs of the people vanished as it appeared the economy had, for the time being at least, eluded the spectre of depression. To be sure, the opposition still drew the connection between debt and taxes and the Social Crediter wondered aloud whether the debt would ever be repaid.[349]

Distribution of the Debt

Blackmore and Quelch led the Social Credit assault on the propertied classes who seemed only interested in the security of their investments and not in the security, vitality, and welfare of the Canadian people. Blackmore disputed the Minister's "pay-as-you-go" policy.

> The tax structure is being prepared to bleed the Canadian people of every last drop of spending power possible of extraction from their emaciated bodies for the next generation. And for what? To pay 3 per cent interest on a twelve billion dollar debt to a few favoured ones.[350]

Victor Quelch also maintained that a comparatively few were snatching up the debt.[351] Quelch stressed the dangers of heavy ownership of the debt by financial institutions and recommended, along the lines of his colleague, Casselman, the sale of non-marketable

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[348]House of Commons, *Debates*, 19th Parliament, 2nd Session, 13 November 1940, p. 70. It was this type of financial policy which Towers and other officials sought to prevent. On March 26, 1942 Towers wrote George Spinney, Chairman of the National War Finance Committee: "Quite apart from the intrinsic undesirability of bank financing on this scale, I believe the repercussions on Parliament and the public would be such that a strong movement would develop for newer methods. *What these new methods might be can, for the moment, be left to the imagination.*" *Public Archives of Canada*, RG 19, Volume 3978, File F-1-6. And during a meeting with bankers in 1942, Towers in an effort to convince bankers to go along with the Government's deposit certificate scheme, warned: "The pressure on the Government to finance through the Bank of Canada is quite heavy. Of course there is not any prospect in the near future of the Government cracking on it but to the layman it looks so easy. He doesn't really understand the evils of such a course." C.B.A. Circular, "Summary of discussion" with Governor Towers, 20 July 1942, p. 2, *The Bank of Nova Scotia Archives*, Secretary's Department Papers 1, File 58.

[349]Robert Fair (S.C., Battle River) questions to the Minister in House of Commons, *Debates*, 20th Parliament, 2nd Session, 1 April 1946, pp. 429-430 and House of Commons, *Debates*, 20th Parliament, 2nd Session, 10 July 1946, pp. 3331-3332. Fair was assured that Canada had always met its interest and principal payments and the Government would continue to do so.

[350]House of Commons, *Debates*, 19th Parliament, 3rd Session, 30 June 1942, p. 3803.

[351]*Ibid*, 16 July 1942, p. 4310.

bonds that could be easily redeemed.[352]

Coupled with this issue was the expressed annoyance of the Social Crediters at the "high pressure" sales tactics of banks and bond dealers to force persons to use credit to purchase bonds by exploiting patriotic sentiment. F.D. Shaw was especially outraged by his constituents' claims that persons were being branded as "subversives" who did not buy bonds, by sales personnel.[353] Victor Quelch echoed this complaint suggesting that the hard sell be stopped and that current, rather than "borrowed" savings, be employed for purchases.[354] These points were acknowledged by both sides of the House who also took exception to the practice of banks and other marketing agents employing credit as a way of meeting their sales objectives. On several occasions, the Minister informed the House that these activities were not encouraged, noting, however that it was difficult to put a halt to this practice when over 100,000 people were engaged in distributing war bonds.

The Social Credit caucus remained highly critical of the banks' ownership of the national debt (the banks held about 20 per cent at the end of the war). *Hansard* indicates that the Social Credit Party representatives believed it was mistaken for the Government to pay for the privilege of receiving this credit from banks chartered by Parliament when the credit supplied should be controlled by the people.[355] Social Credit members Quelch and Johnston were not impressed by Government statements that an internal debt was nothing to worry about. They calculated that less than one per cent of the Canadian public held sixty per cent of the outstanding debt.[356] In Quelch's opinion, this concentration was unhealthy from an economic standpoint for this "asset of the few" tied up investment capital retarding investment in "industry and venture capital"– a curiously tory argument.[357]

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[352] *Ibid*, 17 July 1942, pp. 4375–4376. See also F.D. Shaw, House of Commons, *Debates*, 19th Parliament, 4th Session, 1 March 1943, pp. 805–806.
[353] House of Commons, *Debates*, 19th Parliament, 4th Session, 11 March 1943, p. 1183. "Subversion" frequently was cited as one of the main obstacles to a Victory Loan's successful marketing. The following is an extract from a "Statement of J.L. Ilsley, Minister of Finance re. the marketability of Fourth Victory Loan Bonds," May 1943. "Before every Victory Loan we are deluged with rumours all of which seem to attempt to impair the sale of bonds. The Fourth Victory Loan is no exception. Such rumours are false, vicious, and subversive. I urge Canadians everywhere to do everything in their power to stamp out such rumours." *Public Archives of Canada*, RG 19, Volume 4366.
[354] House of Commons, *Debates*, 19th Parliament, 5th Session, 12 July 1944, pp. 4759–4760.
[355] Victor Quelch, House of Commons, *Debates*, 20th Parliament, 2nd Session, 11 April 1946, p. 758.
[356] Quelch, House of Commons, *Debates*, 20th Parliament, 3rd Session, 15 may 1947, p. 3114 and Johnston, House of Commons, *Debates*, 20th Parliament, 4th Session, 27 May 1948, p. 4492.
[357] *Ibid*.

Quelch expanded on this position in a later Parliament arguing that the huge volume of the outstanding debt had a pernicious tendency to monopolize the savings of Canadians. As long as the Government paid three per cent for its money, Quelch held that Canadian industry would continue to suffer from a shortage of low-cost capital. Quelch therefore advocated the liberation of this pool of savings by using the central bank to buy some of the debt– an old Social Credit recipe for prosperity. In other words, Quelch demanded a redistribution of the debt from the general public and the banks into the hands of the central bank.

Quelch also reiterated his criticisms that only one per cent of individuals and corporations controlled 60 per cent of the debt. This legacy of war could have been ameliorated had the Government accepted the Social Credit's compulsory savings programme. The member from Acadia believed that such a measure, if implemented, would have facilitated the conduct of the war by reducing private consumption.[358]

Summary

Social Credit's influence on the policy-making process was confined, like the C.C..F.'s, to pressing for lower interest rates. Their arguments were used by King and Ilsley to push reluctant officials and chartered bankers into granting concessionary terms on war loans during the war. Social Credit philosophy was based on the belief that interest paid on public debt to private sources was contrary to the public interest and represented a massive financial burden being placed on the current and on future generations. The caucus was not easily convinced by Ilsley's claims that a progressive tax system and an internally held debt would cancel out the effects of this debt burden.

The Senate Discussion

The chamber of "sober second thought" has been generally perceived to be a rest home for the political faithful, a quiet retirement retreat which has not lived up to its role of protecting provincial or sectional interests. Rather, the Senate has dutifully followed the direction laid down by the popularly elected chamber and its executive. Studies have suggested that the Senate has fulfilled a second task outlined for it by Sir John A. Macdonald, that of protecting the minority propertied class. Hundreds of corporate

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[358] House of Commons, *Debates*, 21st Parliament, 3rd Session, 14 September 1950, p. 738.

directorships and kinship links are cited to confirm this bias.[359] In this section, we shall examine the views of the Senators on Canada's public debt as recorded in the Senate *Debates*. No clear or consistent pattern asserts itself which would lead one to believe that the Senate is a stout, anti-deluvian defender of creditors' rights. Not surprisingly,the views expressed tend to be eclectic with no one group of senators that appear to have any special expertise or interest in the area of public debt or debt management. One reason for this is the fact that there were no true monetary reformers in the Upper House until the appearance of G.G. McGeer who served only a year before his death. Lacking any consistent pattern in which to classify the remarks, the investigation will proceed chronologically.

During the Conservatives' term in office, moves were made to tighten up tax collection on the holders of bearer bonds. This tax was based, according to Senate leader, Arthur Meighen on the fact that "the country needs no longer to borrow abroad, and feels that it can safely tax income payable to people outside its borders."[360] This amendment to the *Income War Tax Act* had earlier been advocated by Liberal Senator L.A. Wilson from Quebec who criticized "tax dodgers" who "may be described as human icebergs or as bloodless sharks." Wilson urged the Government "to go after them like a panther. Open their strong boxes and force them to pay their dues to the nation."[361] Wilson in February 1933 introduced a motion for an inquiry "to obtain closer supervision of income from bearer bonds and securities held in trust."[362] The efforts of the Quebec Senator did pay off as the Government sensed popular support for a measure which promised to raise needed revenues from a small group of taxpayers whom many believed were evading taxes.

The Senate debate on the Bank of Canada bill was shortened by the Government's desire to see the legislation passed before the end of the session. As a result, the debate was characterized by partisan wrangling over a bilingual note issue[363] and Liberal J.P.B.

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[359]Colin Campbell, *The Canadian Senate: A Lobby from Within*, (Toronto: 1978)
[360]Senate, *Debates*, 17th Parliament, 4th Session, 15 May 1933, p. 518. In fact what evolved was a tax on foreign and Canadian holders in receipt of interest payments in Canadian funds. (See Chapter VIII)
[361]*Ibid*, 16 November 1932, p. 143.
[362]*Ibid*, 23 February 1933, p. 305.
[363]For example speeches of Arthur Meighen, Leo Dandurand and Thomas Chapais and others in Senate, *Debates*, 17th Parliament, 5th Session, 29 June 1934, pp. 624-643.

Casgrain's near pathological fear of the Bank of England manipulating Canadian finance.[364] The debate which concentrated on emotional issues entirely ignored the crucial issues such as the effect of the new institution on government borrowing practices and the inflationary potential of a central bank which had been stressed by bankers. Nor did the Senators address, in any meaningful way, the issue of private *versus* public ownership of the central bank. The bill, which narrowly made it through the committee stage by a seven to six vote, was passed by a Conservative majority.

The following parliament saw Liberal Senator Lynch-Staunton from Hamilton urge an immediate lowering of the rate of interest.

> I believe that arbitrary legislation with some feature of compulsion may be necessary to bring about such a reduction. Certainly our credit will have to be much higher than it is to-day if such a campaign is to succeed. If arbitrary legislation is enacted, is it not repudiation? Is there any difference between the confiscation of principal and the confiscation of interest? That some readjustment in the bonded indebtedness of this country is essential is apparent to all. How to bring it about is the question. That there must be a readjustment with the debtor class in this country if we are to have a return to prosperity is as clear as day. There can be no prosperity when our farmers are "broke". How is this readjustment to be made? At the expense of the creditor class, of course.[365]

This statement was similar in content to the analysis made by Professor MacGregor and other academic economists to the effect that it was vitally important to redress the terrible inequity which arose from the drop in commodity prices penalizing the debtors and rewarding creditors beyond their just desserts.

After the Liberals returned to power, Charles Dunning's Loan Council proposal was put before the Senate and became the subject of long-winded speeches. Lynch-Staunton recounted his travels in the Sudan while other Senators searched for the *true* meaning of Confederation.[366] In a rare show of support for provincial autonomy, the Senate defeated the proposed joint resolution to amend the B.N.A. Act with Sir Thomas Chapais a Conservative from Quebec labelling the move "dangerous under the present circumstances."[367]

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[364] *Ibid*, 28 June 1934, pp. 602-610.
[365] Senate, *Debates*, 18th Parliament, 1st Session, 29 April 1936, pp. 203, 217.
[366] Senate, *Debates*, Sir Charles Aylesworth (Liberal, Ontario) 2 June 1936, p. 411, Arthur Marcotte, (Conservative, Saskatchewan), 15 June 1936, pp. 499-503 and C.P. Beaubien (Liberal, Quebec) 17 June 1936, pp. 530-533.
[367] *Ibid*, 3 June 1936, p. 421.

During the following session, John Haig, a Conservative from Winnipeg, returned to the theme of the debtor–creditor relationship. Pointing to Alberta's recent default, Senator Haig warned his colleagues not to "make fun" of Social Credit. Senators ought to be vigilant to the rising tide of demands for debt reduction in the West, Haig advised.[368] Haig's comments were challenged by another Manitoban, Senator McMeans who allocated blame for the financial crisis on the respective western provincial legislatures. Noting that "no financial institution which has a board of directors in Montreal or Toronto will lend a dollar in the West," McMeans chastized the provinces for "the awful legislation" they are passing,[369] adding,

> How can they expect to get along after they drive every financial institution outside of their borders? They come to the Dominion Government and say: "We are hard up. We have no money and we cannot collect what is owing to us." But, I repeat, they are in this condition because of their own laws. It seems to me that unless there is some control over the legislation of these provinces we must expect the present condition will continue to exist.[370]

In Chapter III, we noted that by early 1939, there was evidence to indicate that the so–called economic recovery had been stalled and a return to, or maintenance of, high levels of unemployment was a very real possibility. In this climate, Arthur Meighen spoke of the need to wean Canadians with wealth from their habit of holding bonds. The logical outcome of this practice, according to Meighen, was that government bonds and money would eventually "become worthless."[371] Meighen's solution was vintage supply side economics– unless industry could operate to pay the interest on the debt, Canada as a nation could not prosper. This meant that government expenditures had to be held down below revenues facilitating the flow of capital to business, not to government.[372]

During the war, there was very little discussion of the large borrowing requirements. Typically, loan bills passed by the Commons received all three readings in one or two days with very few questions or comments elicited. [373] Occasionally, venerable Senators, like Eugene Paquet from Lauzon, Quebec would address the significance of the Victory Loan campaigns designed to defend freedom and stave off "an abyss of untold

[368]Senate, *Debates*, 18th Parliament, 2nd Session, 20 January 1937, pp. 20–23.
[369]*Ibid*, p. 29.
[370]*Ibid*. McMeans also attributed the debt reduction legislation to the fact that most of the western M.L.A.'s were debtors themselves.
[371] Senate, *Debates*, 18th Parliament, 4th Session, p. 21.
[372]*Ibid*.
[373]For instance the Loan Act passed in June 1942, Senate, *Debates*, 19th Parliament, 3rd Session, 10 June 1942, pp. 182, 199–200.

misery."[374]

After the war, the financial and economic concerns of Senators turned to the issues of the external value of Canada's dollar, the price level, de-controls and rising interet rates. Arthur Roebuck, a Liberal from Toronto,spoke out vigorously against the institution of controls which Abbott had claimed were not at all cumbersome to business.

> But a free economy is the last thing desired by the bureaucrats of this, or any other country. The Marxian philosophy of a controlled economy has prevailed. Canada, Great Britain, and all the rest have maintained fixed rates of exchange and have endeavoured to beat the market by all sorts of compulsions and restrictions, quotas, tariffs, and so on which have harassed the business world.[375]

This McCarthyesque free enterprise view was also shared by Senators Haig and R.B. Horner (Conservative, Blaine Lake, Saskatchewan), the latter articulating the view that the Liberals, the C.C.F. and the Communists were all one and the same in their drive towards a planned and regimented economy.[376]

This dislike for regulation and control was again in evidence in 1951 when debate on second reading of the National Housing Bill occasioned an attack on the Government's and central bank's interest rate policy. Senator Haig, the Conservative Leader in the Senate questioned the wisdom of a "forced rate" of 3 per cent designed to keep interest charges down. Haig also attacked the Government's handling of the Victory Bond price support programme. He pointed to the public's misperception that Victory Loans could be sold at par (100 cents on the dollar) at any time even though "the government had never said the bonds would be maintained at par, (that) there was no legislation to maintain them at par."[377] This misunderstanding, which proved to be embarrassing to Abbott and his officials, was costly to many patriotic Canadians who purchased bonds in good faith expecting no loss of principal, only to discover when they needed cash that they were trading at a "discount" of six or seven cents on the dollar.

Haig's comments sparked a former Liberal Cabinet Minister, E.D. Euler (Liberal Waterloo) to observe that falling bond prices was having a damaging effect on provincial hydro bonds. "This destruction of public confidence," Euler remarked, "is to my mind most

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[374] Senate, *Debates*, 19th Parliament, 4th Session, 5 February 1943, p. 61.
[375] Senate, *Debates*, 21st Parliament, 1st Session, 28 September 1949, p. 55. See also comments of Prime Minister King footnoted above, Section (iii).
[376] *Ibid*, 5 October 1949, p. 88.
[377] Senate, *Debates*, 21st Parliament, 4th Session, 5 June 1951, p. 532.

unfortunate."[378] Several weeks later, Haig returned to the theme of falling bond prices, holding

> It all comes about by reason of the fact that the Government of Canada is spending too much money; investors in government bonds are afraid of their securities and are demanding higher interest rates. The Dominion Government has now reached the stage– though Mr. Towers will not admit it– where it has not got enough money to liquidate the bonds, and as a result their market value has declined and the general rate of interest is going up.[379]

As a consequence of this development, provinces and municipalities would have to pay more than 3.5 per cent for their money, Haig stated.

During the following session, a new member of the Senate from St. John's, A.B. Baird returned to the problem of the small investor losing money when selling Victory bonds. Baird quaintly rebuffed Liberal Senator Robertson's claim that these bonds were a good investment *if held until maturity* when stating this was "saving in another direction." "To buy at 99 and sell at 91," Baird declared, "does not represent my idea of a good investment."[380]

Summary

The discussion of the Social Credit gospel was excluded from the Senate's agenda. In spite of the absence of the social credit vocabulary, there was some sympathy for the plight of the debtor although the tone of the Senate discourse was conservative in sentiment in the sense of respect for contract and antipathy for an economy planned by "bureaucrats". The focus of the Senate's concerns about the debt shifted from a preoccupation with interest rates during the depression to endorsation of the Victory Loans during war–time to a mild criticism of the Government's sudden return to controls on 1948 and the interest rate policy commencing in 1950. The issue of capital losses facing the small subscribers seems to have been taken more seriously by the Senate than by the House of Commons. Why this was so, is not clear. In sharp contrast to the strident criticism of the banks and the debt creating system heard in the lower chamber, few attacks on the bank's loan policies were placed on record. Criticism was normally directed at the Government in "the other place" or innocuously at creditors who ought to be prepared to compromise to avoid losing everything. With the exception of Wilson's

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[378] *Ibid*, p. 532.
[379] *Ibid*, 20 June 1951, p. 600.
[380] Senate, *Debates*, 21st Parliament, 5th Session, 26 November 1951, p. 138.

proposals to institute a tighter tax collection regime, the overall impression that is left of the Senate is that of a mildly irrelevant legislative anachronism self-consciously going through the motions of vetting legislation proposed elsewhere.

Summary

In concluding this chapter which serves as background to the political ideas influencing the debt management process, the following general conclusions are offered.

1. The Liberals held a far more flexible and pragmatic attitude to the question of public debts than did the Tories and the Social Credit. The Tories subscribed to the traditional view of public debts as implying burdens while the Liberal Government's view evolved towards a macro-economic, benign approach. Social Crediters held a dogmatic view that the banking system was essentially a gigantic fraud being perpetuated on the people. Calls for the elimination of the debt creating system and the issuance of debt free money were standard offerings of the members from Alberta.
2. Public sector budgeting including decisions on taxation was strongly influenced by the proximity to election time. The King diaries confirm the opposition's suspicions that tax increases and decreases were a principal part of the Government's overall election strategy. Although the Liberal Government had adopted counter-cyclical budgeting, Wagner's concept of economic manipulation for political profit was certainly evident.
3. The Social Credit and C.C.F. influence was primarily felt in the area of interest rates. Their demands were picked up by politicians and officials and used to counter the bankers' arguments for higher rates of return on government paper. (See Chapters V and VI) The C.C.F.'s electoral success also had an important effect in driving King's Liberals towards a financial philosophy which was in sympathy with Keynesian economic theory. The threat of a "contagion from the left" was used several times in pushing certain social programmes through the Cabinet and the Department of Finance.
4. Although debt management *per se* was never front page news, the *rate of interest, the volume of debt outstanding and the role of the banks* became highly charged

political issues directly related to public debt and debt management.

5. There existed general agreement that an internally held debt was more manageable for a country than external debts.
6. There was recognition that debt does pose problems of an intergenerational nature. Therefore the repayment of debt was a good idea when the country was in a position to retire its debts.

In the next chapter, we shall investgate the objectives and constraints on debt management from an *administrative perspective*. As we shall discover, the impact of these preceding debates on the minds of policy-makers was minimal giving some credence to technicians' arguments that debt management is essentially apolitical. Nevertheless at certain points during negotiations with institutional creditors, bureaucrats did introduce political arguments to reinforce their case for lower interest rates or financial sacrifice.

V. OBJECTIVES AND OBSTACLES. AN ADMINISTRATIVE HISTORY

In this chapter, an examination of the particular goals of debt management will be made and contrasted with the various constraints encountered by officials in the Finance Department and the Bank of Canada. The survey is broken down into four periods:

1. Depression prior to the establishment of the Bank of Canada in March 1935.
2. Depression period after the Bank's opening until the outbreak of World War II.
3. The war period taken to be September 1939 to December 1945.
4. The post-war period from 1946 to December 1952.

This investigation aims at identifying the primary and subsidiary goals pursued and the particular factors which hampered achievement of these goals.

Objectives

At this juncture, the main goals of debt management should again be recapitulated. These objectives are:

1. To ensure that an issue brought to market is absorbed with a minimum of disturbance to the prices of outstanding issues traded in the secondary market.
2. To minimize interest and borrowing costs to the issuer by ensuring the bonds are priced competitively. This may involve selling bonds with a shorter term to maturity as shorter-term securities earn lower rates of return.
3. To broaden the market in government securities by selling to as wide a group of investors as possible. A wide placement implies less fluctuations in price should any group of institutional investors be forced to liquidate their holdings.
4. To maintain a balanced spread of maturities in order to avoid an extremely heavy refinancing operation at one point in time. This goal necessitates periodic funding operations.
5. To provide flexibility in operations by not adhering in a doctrinaire way to a set formula on debt management. Flexibility can be achieved by a variety of means including improved spacing of maturities, the use of auctions for longer term bonds, call features and the issue of extendible or retractible bonds.

Constraints

The main constraints confounding the achievement of the foregoing objectives include:

1. *Form of the Debt.* The existence or absence of call features, 2 or 3 pay bonds (optional-pay bonds), tax-exempt features like American municipal bonds, non-marketable debt instruments which can be cashed at any time e.g. savings bonds, savings certificates, are all examples of important variables which reduce or provide flexibility to the debt manager.
2. *Market Conditions.* Canada's relatively undeveloped capital market took its direction from London and New York. Hence, international developments such as key elections or defaults had a crucial influence in setting the market tone and thereby

the course of Canadian interest rates which moved in sympathy to developments in both the U.K. and the U.S. Domestic factors too had a significant effect; for example the Alberta election of August 1935.

3. *Investor Resistance*. As one life insurance executive stated before the Porter Royal Commission, "the only way you can influence the rate on the next one is not to take this one. You cannot change the rate on this one."[381] Resistance by chartered banks in the early 1930s took place over the rolling over of maturing issues. The banks as a collective unit were in a particularly strong position to influence the outcome of the negotiating process.

4. *Inflation, bank borrowing and monetary policy*. This question was crucial during and after the war. Sales of debt to the banking system (including the central bank) leading to a rapid growth in the money supply were likely to have inflationary consequences *if* production did not correspondingly increase. This "easy method" of financing was shunned in favour of heavier taxes but to a degree. Complicating the problem of bank borrowing was the perception that the banks were "living off" government bonds and were not adequately providing for Canadian industry. Immediately after the war, the conflict between interest rate minimization and an anti-inflationary monetary policy became evident.

5. *Political Factors*. The calls by Social Credit for more central bank financing and the C.C.F.'s demands that interest rates be brought down to practically nothing, did give the central bank some ability to use these demands as a lever against the chartered banks. At the same time, central bankers had to be cognizant of the fact that should a widespread perception grow that the central bank was at all sympathetic to the inflationary calls of Social Credit, a crisis of confidence would soon arise. The most important political constraint however were commitments made by Towers with the tacit support of Ilsley on bond price maintenance after the war. This essentially tied politicians' and officials' hands in using the interest rate as one means of fighting inflation.

1930-March 1935

Objectives

The main objectives of debt management at this time were two-fold: 1) to advance refund the huge maturities due between 1933 and 1937 and 2) to refund the debt at rates well below the five and five and one-half per cent Victory Loans issued during the Great War. Secondary considerations related to the elimination of tax-exempt features.

Very early consideration was given to this issue of refunding well before the dates of maturity. J.H. Gundy, President of Wood Gundy, in the capacity of an unofficial financial advisor, prepared a lengthy memorandum for the then Finance Minister Charles Dunning, in which he noted:

> The amount of re-financing to be done in 1933, 1934 and 1937, aggregating approximately One Billion Two Hundred Million Dollars, constitutes a problem that will be too heavy if left to the time of maturity. There is no doubt in my mind it should be dealt with without any further delay, as the first maturity of

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[381]Testimony of W.J. McCarthy of the Canadian Life Insurance Officers Association, *Proceedings*, Royal Commission on Banking and Finance, Volume 24, Ottawa, 9 July 1962, p. 2486.

> $447,000,000 is only three years from next November followed by a maturity of $512,000,000 one year later.[382]

This propoal was put on hold until after the June 1930 election, but afterwards the question of an early refunding scheme was actively pursued by the Toronto financier Gundy and officials of the Department of Finance. It was evident that the new administration was in fundamental agreement with the thrust of the Gundy memorandum and the urgency of the refunding operation. Early refunding, in the mind of Watson Sellar, Acting Deputy Finance Minister would alleviate undue pressures on the domestic capital market, improve the term to maturity structure and avoid "last minute reliance" on New York.[383] These arguments were also articulated by Finance Minister and Prime Minister Bennett when announcing the May 1931 conversion loan which was designed "to do something to remove the dark cloud " of heavy financing from the horizon.[384]

Documents relating to the resumption of conversion talks with Gundy in the Autumn of 1930 illustrate official reticence to the prices offered and commissions requested. Commenting on a proposal put forward in mid-October,[385] the Chief of the Public Debt Division found the charges asked to extinguish the tax-exempt feature too high and the price to the public too low compared with outstanding issues then traded.[386] In a follow-up memorandum for the Minister prepared by Sellar the offer was allowed to lapse as the spread of $1.75 was "too large in favour of the Syndicate." "I am satisfied," added Sellar, "that the Canadian banks will hold on to theirs, and I cannot see any hope of getting 1933 tax-exempts from rich men who are paying in excess of 25 % income tax, therefore, I do not think the Government should be penalized in interest rates in testing out a hypothetical project."[387]

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[382] J.H. Gundy to Charles Dunning, 31 March 1930, *Public Archives of Canada*, RG 19, Volume 592, File 155-30, "Financing 1930 (Canada)," Volume 1.
[383] Watson Sellar to Acting Finance Minister A.B. Ryckman, 29 September 1930, *Public Archives of Canada*, RG 19, Volume 592, File 155-30.
[384] House of Commons, *Debates*, 17th Parliament, 2nd Session, 8 May 1931, p. 1383.
[385] "Memorandum to Acting Finance Minister Ryckman from Bank of Montreal, Dominion Securities, Royal Bank of Canada, Wood Gundy, A.E. Ames, and Canadian Bank of Commerce," 11 October 1930, *Public Archives of Canada*, RG 19, Volume 592, File 155-30.
[386] B.J. Roberts to Watson Sellar, "New Issue and Conversion," 12 October 1930, *Public Archives of Canada*, RG 19, Volume 592, File 155-30.
[387] Watson Sellar to Acting Finance Minister Ryckman, 13 October 1930, *Public Archives of Canada*, RG 19, Volume 592, File 155-30.

The Quest for Lower Interest Rates

The main push for *lower interest rates* came during the summer of 1932. With the continuing deflation and low demand for industrial credit, the British government during 1932 floated a very successful conversion loan. This operation set the tone for the domestic market.[388] Adding support to this direction were Canadian pronouncements at the World Monetary and Economic Conference in 1932 promising Canadian co-operation in bringing the rate of interest down further. According to a memorandum prepared by the recently appointed Deputy Minister of Finance, W.C. Clark:

> Absolute necessity for gradually effecting a lowering of interest rates in this country. *If this cannot be achieved by normal processes, we will probably face irresistable pressure for compulsory conversion of outstanding debts on an arbitrary basis.* We believe it to be very much in the interest of the banks themselves to co-operate wholeheartedly with the Government in the attempt to effect a reduction in the interest burden by normal economic processes.[389]

The bogeyman of default or compulsory and arbitrary conversion was used by Clark in negotiations with the chartered banks again in July 1934. According to the C.B.A. record of the meeting, the Deputy felt *short-term rates* must be brought down as quickly as possible. "Unless this was accomplished soon," the minutes record, "he [Clark] felt that there would develop a strong public attitude in favour of repudiation and scaling down of debts."[390] Subsequently, the downward movement of rates was accomplished, in the main, through secret negotiations between the Dominion, the banks and the trust industry, which effected a lowering in the rates paid to depositors.[391] Lower deposit costs, in turn, were passed on to the Dominion in the form of lower interest rates for conversion and cash loans.

Secondary goals related to the elimination of the tax-exempt feature which Bennett enunciated as government policy in May 1931.[392] With respect to the

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[388]George S. Watts to author, 28 July 1982.
[389]"Agenda for Meeting with bankers, 26 May 1933," *Public Archives of Canada*, RG 19, Volume 592, File 155-30, and C.B.A. Circular 104-F, 27 May 1933, *The Bank of Nova Scotia Archives*, Secretary's Department Papers 1, File 61.
[390] A.W. Rogers to H.F. Patterson, General Manager, 20 July 1934, Enclosure: "Minutes of a Meeting of the minister of Finance [Hon. E.N. Rhodes] and Deputy Minister [W.C. Clark] with the President and Senior Vice-President of the Association, held in the Office of the Minister at Ottawa, on Thursday July 19th, 1934," *The Bank of Nova Scotia Archives*, Secretary's Department Papers 1, File 57.
[391]C.B.A. Circular 120-P, 25 September 1934, "Minutes of a Conference Held at the Request of the Minister of Finance at Ottawa on Monday 24th September 1934 Relative to the forthcoming conversion loan," *The Bank of Nova Scotia Archives*, Secretary's Department Papers 1, File 57. (See Chapter VI)
[392]House of Commons, *Debates*, 17th Parliament, 2nd Session, 8 May 1931, p. 1383.

distributional aspects of the debt, as noted above, Finance Minister Edgar Rhodes had argued that the costs of wider placements exceeded the benefits. With the exception of the National Service Loan of November 1931 and the October 1934 Refunding Loan, there was very little encouragement given to small investors to subscribe and/or convert their holdings.[393] With the creation of the Bank of Canada, however, a far more positive approach was taken to the sale of government debt to the small subscriber.

Another subsidiary objective of debt management during this period was the commencement, in August 1934, of the *fortnightly treasury bill auctions*. The bidders were limited to the chartered banks who bid on bills with a maturity of one year or less on bills which then yielded approximately two per cent. This development aided the Government in minimizing its interest costs– shorter–term debt being less expensive than long term debt. Moreover, it set the basis for an inter–bank market in short–term government paper which ultimately became a full–fledged money market in the early 1950s. By March 1935, there was approximately $150,000,000 in treasury bills held by the Canadian banks representing about five per cent of the direct national debt. It is interesting to note that all bill trading took place between the central bank and individuals banks– there was no inter–bank trading in the early years.[394]

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[393]R.B. Bryce, "Borrowing and Debt Management," January 1982, unpublished manuscript.
[394] See Neufeld, 1958, p. 49. "Before the 1953–4 changes in the money market, trading took place almost entirely between the chartered banks and the Bank of Canada, and not between one chartered bank and another. There were several reasons for this. First of all, and most important, the Bank of Canada never refused to buy Treasury bills and did not exact a penalty rate, since the Bank was concerned to maintain their liquidity. Second, by selling to the Bank the chartered banks could adjust their reserves more quickly than by selling to other banks or customers of other banks. Third, selling to the bank concealed the operation from competitors."

TABLE 5.1
Unmatured Debt, Net Debt, Average Rate, 1930-1935

Year	Funded Debt (1)	Average Interest Rate (2)	Net Debt Per Capita$Cdn (3)	Interest per capita $Cdn (4)
1930	2,227	4.97	213.34	11.91
1931	2,319	4.93	217.97	11.69
1932	2,502	4.92	226.06	11.53
1933	2,650	4.85	244.19	12.70
1934	2,789	4.59	254.16	13.01
1935	3,007	4.14	262.44	12.77

SOURCE: *Canada Year Book*, (1930-1954).

TABLE 5.2
Interest, Deficit in relation to GNE, Government Expenditure, 1930-1935

Year	Interest (1)	Interest %Govt. Expend. (2)	Interest % GNE Factor (3)	Deficit % Govt. Expend. (4)	Deficit/Surplus % GNE Factor (5)
1930	123	31	2.8	-31.9	-2.2
1931	122	28	3.1	-45.5	-4.1
1932	125	28	3.7	-43.6	-4.2
1933	136	26	4.0	-32.1	-3.3
1934	141	31	3.6	-24.4	-2.4
1935	139	29	3.3	-28.8	-3.0

SOURCES:-Column (1) *Public Accounts of Canada*, for the year ending March 31, various years. (Columns (1), (5)- millions Canadian dollars)
Columns (2),(3), (4) Cansim Mini Series identifiers: D 30580 (Interest), D30591 (Expenditure), (5) GNE at factor Cost, *Canada Year Book*.

Obstacles

The major constraints faced by Finance officials were 1) unsettled market conditions at home and abroad, 2) the tax-exempt, non-callable feature of the war loans, and 3) the large volume of maturing debt held by the banking sector.

Market Conditions

One of the initial factors which destabilized international capital markets was the Latin American situation. With the collapse of commodity prices in 1930, the ability of the staple exporting nations of Latin America (coffee, beef, wheat, copper) to sustain their existing indebtedness was placed in doubt. In September 1930, a sharp break in the market occurred as a consequence of investors' fears that negotiations then underway

between international creditors and national debtors would break down leading to default or repudiation. The real *coup de grace* came a year later with England's abandonment of gold which introduced a wave of fear and a distrust of most debt instruments with the exception of securities of the stable democracies. Even before England's flight from the gold standard, Watson Sellar termed the New York market "disorganized" in face of fears that the savings bank system was ready to collapse.[395] After the British announcement on 21 September, a "drastic drop in the price of U.S. securities " took place in which the yield of 90 day treasury bills rose more than 110 basis points between the end of September and the third week in October.[396]

The unsettled nature of capital markets at this time made the *timing* of trips to the markets exceptionally tricky. For example, the Fall of 1932 refinancing in New York had to be completed well before the Presidential elections to avoid the possibility of a decline in bond prices.[397] The unsettled character of the markets is verified by testimony presented before the Royal Commission on Banking and Currency by the Investment Bankers Association of Canada in September 1933. Ward Pitfield, President of the IBAC, noted that bond dealers could no longer offer firm bids for bonds "for fear that government policies changing overnight."[398] In the wake of the September 1931 fiasco which caught a number of dealers with bonds in inventory whose value declined dramatically, dealers were much more cautious in making commitments to borrowers on price. The dealers' caution was reinforced by their precarious financial position, a position of under-capitalization which subordinated some firms under the direction of the chartered banks.[399]

In Canada, municipal defaults in the early 1930s and rumours of impending defaults had a strong negative psychological impact on the market. As a consequence, there was a movement away from industrial bonds into the debentures of the most credit-worthy governments, ("gilt-edged" securities), specifically the Dominion and the Province of

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[395]Watson Sellar to R.B. Bennett, "Memorandum re. Bond Prices," 1 September 1931, *Public Archives of Canada*, RG 19, Volume 592, File 155-30, Volume 2.
[396]Watson Sellar to R.B. Bennett. "Memorandum re. Interest Rates," 21 October 1931, *Public Archives of Canada*, RG 19, Volume 592, File 155-30, Volume 2.
[397]"Memorandum to Minister," 9 September 1932 and "Memorandum to Minister Re. Financing 1932," 12 September 1932, *Public Archives of Canada*, RG 19, Volume 592, File 155-30, Volume 2. (See also Chapter VIII)
[398] *Proceedings*, Royal Commission on Banking and Currency, Ottawa, 12 September 1933, p. 3095.
[399]*Interview*, 1 June 1982 and *Interview*, 26 May 1982.

Ontario. In October 1932 Vancouver defaulted and the City of Windsor called for a 5 year halt on bond repayments. That December, Calgary refused to pay a $300,000 exchange premium on funds destined for the United States. By 1934, the total defaults of Ontario municipalities reached $84,000,000 with Quebec well behind with defaults of $15,000,000.[400] The major source of domestic instability was first observed at the level of municipal finance and was the result of a narrow and highly variable revenue base. In later years, fears of default shifted to the arena of provincial government finance, notably to the four Western provinces.

During the 1930–1932 period, there is no indication that municipal defaults posed a great threat to the financial integrity of the Dominion. Thus, while these domestic defaults did much to undermine the assets of some financial institutions, the market tone for the "bell-weather", gilt-edged Canada bonds was set elsewhere. This is why, as we shall document, the Dominion was acutely sensitive to interest rates movements in New York and London and to the political and financial developments in those countries.

Form of the Debt

The refunding of large maturities was "made somewhat acute", according to Watson Sellar by the "absence of callable features which might expedite refunding" and the "presence of tax exemption features."[401] The absence of callable features forced the Dominion, as borrower, to offer a substantial inducement to holders to convert their debentures before maturity dates (advance refunding). As there was no question that the Dominion would arbitrarily abrogate its contract with respect to call and tax-exempt features, the offer to holders of bonds included extra "talons" attached to the bonds which carried the tax free privilege for the 1931 (1 talon), 1933 (3 talons) and 1934 (5 talons) maturities. All holders would receive the rate of interest originally contracted for until the date of maturity after which the interest rate dropped from 5.5 per cent or 5 per cent to 4.5 per cent. The Dominion decided against buying out the holders of these bonds by offering a bonus payment which might have been politically damaging since it was

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[400] Incidentally, Alberta's default record was second best to British Columbia's (0.6 per cent of total debt) while Ontario's was the highest (19.1 per cent of total outstanding debt). See Thomas Bradshaw, February 1935, pp. 120–122. Bradshaw headed up an Ontario Government inquiry into municipal defaults and later became an original member of the Executive Committee on the Bank of Canada.

[401] Sellar to Acting Finance Minister Ryckman, 29 September 1930, Sellar to Ryckman, 12 December 1930, *Public Archives of Canada*, RG 19, Volume 592, File 155–30, Volume 1.

believed most bonds were closely held by estates and corporations instead opting for a programme to refund in advance of maturity to minimize the potential for troubles when such large issues hung over the markets.

The Conversion Loan of May 1931 aimed at the conversion of only $250,000,000 of four issues maturing between October 1931 and November 1934. Table 5.3 below indicates what issues were converted and the percentage of each issue converted. Table 5.3 shows the investor response to the offer was extremely good for the Dominion received conversion requests for nearly sixty per cent of the maturities while only aiming for twenty-five per cent. The issue was unique in the sense that all tranches (years remaining to maturity) were callable ten years before the final maturity date with sixty days notice. Bennett estimated the annual savings from this operation to be approximately six million dollars per annum.[402] This highly successful conversion loan was subsequently followed by Refunding Loans in 1933 and 1934 which converted approximately $475 million.

TABLE 5.3

1931 Conversion Loan

Maturity Date	Outstanding	Converted	Percentage Converted	Annual Savings
5's of 1 October 1931	$53,000,000	$38,400,000	72.45	$197,000
5.5's of 1 November 1932	$73,000,000	$37,000,000	50.68	$370,000
5.5's of 1 November 1933	446,000,000	$273,200,000	61.26	$2,732,000
5.5's of 1 November 1934	$511,000,000	$278,200,000	54.44	$2,782,000
Totals	$1,083,000,000	$626,900,000	57.89	$6,071,000

SOURCES: House of Commons, *Debates*, 17th Parliament, 3rd Session, 6 April 1932, p. 1756.

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[402]House of Commons, *Debates*, 17th Parliament, 1st Session, 8 May 1931, p. 1383.

Bank Negotiations

The last major constraint faced by Finance officials in the pre–Bank of Canada era was the concentrated ownership of the national debt. Although chartered banks' financial statements did not segregate out Dominion and Provincial securities holdings in their financial statements at this time, their total securities portfolio grew from $342 million in 1929 to $683 million by the end of 1934. The banks' perference for the highest quality, gilt–edged securities compelled the Dominion to negotiate rates for new, cash issues and conversion issues *directly* with representatives of the chartered banks. Thus the true, arms–length, impersonal market relations between issuer and buyer of securities was vitiated.

Under the aegis of the Canadian Bankers' Association, at least seven meetings were arranged between September 1932 and September 1934 with the Minister and his senior officials.[403] Over a similar time period, there is no record of any official or informal meetings held between the Government and representatives from the life insurance or trust industry. This is a fairly clear indication of the Government's need to receive assurances from the banking community that renewals would be made of the large volume of *maturing* Dominion stock in the hands of the banking system. It should be pointed out here that the very nature of commercial banking led the banks to take a strong position at the "short–end" of the market to match their short–term deposit liabilities with

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[403]Watson Sellar, "Memorandum to File," 27 September 1932, *Public Archives of Canada*, RG 19, Volume 592, File 155–30, Volume 1; C.B.A. Circular 94–Y, "Minutes of Conference with Minister of Finance at the Bank of Montreal, Tuesday, 27 September 1932," *The Bank of Nova Scotia Archives*, Secretary's Department Papers 1, File 61; C.B.A. Circular 95–U, "Minutes of Meeting with the Prime Minister and Minister of Finance with the members of the Association held in the office of the Minister of Finance in Ottawa, Monday, October 17th, 1932," *The Bank of Nova Scotia Archives*, Secretary's Department Papers 1, File 61, C.B.A.Circular 104–F, 27 May 1933, *The Bank of Nova Scotia Archives*, Secretary's Department Papers 1, File 61; W.C. Clark, "Agenda for meeting with bankers, May 26, 1933," *Public Archives of Canada*, RG 19, Volume 592, File 155–30, Volume 3; C.B.A. Circular 108–Q, 16 September 1933, Meeting with Prime Minister, *The Bank of Nova Scotia Archives*, Secretary's Department Papers 1, File 61; C.B.A. Circular 108–X, 2 October 1933, "Minutes of a Conference, Wednesday 27 September 1933 with the Right Honourable R.B. Bennett, Prime Minister, Relative to the forthcoming conversion loan," *The Bank of Nova Scotia Archives*, Secretary's Department Papers 1, File 61; A.W. Rogers to H.F. Patterson, General Manager, 20 July 1934, Enclosure: "Minutes of a Meeting of the Minister of Finance [Hon. E.N. Rhodes] and Deputy Minister (W.C. Clark) with the President and Senior Vice–President of the Association, held in the Office of the Minister at Ottawa, on Thursday July 19th, 1934," *The Bank of Nova Scotia Archives*, Secretary's Department Papers 1, File 57; and C.B.A. Circular 120–P, 25 September 1934, "Minutes of a Conference held at the request of the Minister of Finance at Ottawa on Monday, 24th September 1934, relative to the forthcoming conversion loan," *The Bank of Nova Scotia Archives*, Secretary's Department Papers 1, File 57.

short–term, marketable assets. This balance sheet reality led naturally to their preference for short–term government bonds, a preference which was accelerated by the liquidation of commercial and agricultural loans in the early 1930s.

The major point to be underlined is the non–market, non–arms length relationship between the Dominion as debtor and the banks as creditor. Officials, in attempting to assure themselves of a successful cash or conversion issue *attempted to minimize uncertainty* with respect to the issue's success by direct, formal contact with the holders of the largest stake in government debt. This drive to minimize uncertainty is consistent with the analysis advanced by David Good in his *Politics of Anticipation: The Making of Federal Tax Policy*.[404] Good's analysis of recent federal tax policy–making concludes that the Department of Finance attempts to *anticipate* the possible reaction of various "attentive publics" to new tax changes. These "attentive publics" include tax accountants and tax lawyers and more generally the financial and business communities. This process of anticipation is designed to minimize any embarassment that might occur when new tax initiatives are brought in. What is different about the budget process is that it tends to be shrouded in much more secrecy, whereas the pricing negotiations, though conducted behind closed doors, were informed by price movements occurring on the secondary market. There was less danger that tentative prices agreed at these meetings could personally benefit individuals and individual banks than would leaks involving tax measures. With the creation of the central bank, however, the whole question of bond pricing and interest rate movement became far more secretive and is reflected in the Bank's near pathological secrecy surrounding its bond trading activities.[405]

In summary, the vast holdings of *maturing* and tax–exempt obligations placed the Government in a delicate situation. Lacking an operational central bank which could repay its debts through the issue of more legal tender to the banks, the Finance Department needed to be certain of the co–operation of the chartered banks if these conversion operations were to be successful. To be sure, the unwillingness of the banks to increase their commercial lending made them, in a sense, captive holders of government debt.

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[404](Ottawa: 1980)

[405]See Royal Commission on Banking and Finance, *Report*, p. 324. The Commission believed that the Bank had gone too far in its desire to keep its interest rate policies secret to avoid any charge that market participants could benefit unduly from interest rate movements.

Nevertheless, the government's incapacity to issue legal tender gave the banks considerable power to dominate the pricing decisions of governments. With the establishment of the Bank of Canada and its monopoly over the note issue, this dependence on the banking system was never quite the same again. After 1935, the Government had an agent capable of issuing legal tender bank notes and holding large amounts of maturing government debt– a privilege and power heretofore granted exclusively to less than one dozen private corporations.

March 1935-August 1939

On March 10, 1935 the Bank of Canada opened for business. In commencing its operations, the Bank received approximately $180 million in gold from the Government's central gold reserve, $5 million in equity from shareholders and $30 million in treasury bills and $115 million in Government of Canada guaranteed securities maturing in 1940 from the Dominion. The Bank's major liabilities were, by the end of December of 1935, $57 million in bank notes in circulation, chartered bank deposits and reserves with the Bank of $226 million and Government deposits of $32 million (Table 5.4).

Through its "open market operations", the central bank as buyer and seller of provincial and dominion government securities could affect the volume of cash reserves in the banking system and thereby the volume of bank credit.

> A central bank's influence on the volume of credit arises from its power to affect the volume of commercial banks' cash reserves. When a country is not on the gold standard, the central bank can do more than affect the commercial banks' cash reserves; it determines them. If the central bank increases its assets, by buying gold or securities, or making advances, such action will be reflected by an increase in its deposit liabilities. For the most part, in our case, these deposit liabilities are the balances which the chartered banks keep with the Bank of Canada as part of their cash reserves. An expansion of cash reserves tends to produce an increase in the commercial banks' loans and investments; a contraction of reserves tends to produce a curtailment of these assets.[406]

During the initial phase of the Bank's operations, there was a concerted effort to expand the money supply with a view to increasing price levels and economic activity. In this period there was no conflict between the monetary management objectives of the central bank– a "cheap money" policy, and the debt management objectives of the Government,

[406]Bank of Canada, *Annual Report*, 1935, (Ottawa: 25 February 1936), p. 11.

that is to say, low interest financing.

Objectives

The major objective of debt management during this period was the establishment of a broader and deeper market for government debt and the movement towards a more finely tuned, impersonal set of market relations. This meant an end to consultations with the banks preceding loans. The achievement of these goals was a *sine qua non* for monetary policy based on open market operations requiring a highly sensitive, broad market in government debt which was certainly lacking at this time. Indeed, one of the few objective criticisms made by the Bankers' Association to the establishment of a central bank was that Canada lacked a money market.[407] Professor R.S. Sayers has written in this regard:

> The growing doubt that eventually checked the multiplication of central banks was, however, not the basic questioning of the theory but rather reflection upon the experience of some of the infants. *In one country after another open-market operations were just a dream; because there was no market in which to operate.* The member banks were powerful institutions; many of them free to draw upon their own offices in the world's leading financial centres and never needed to go near the central bank, whose rediscount rate remained completely inoperative, published in the pious hope that someone would notice what it was.[408]

The goal of broadening the market for government debt was also designed to drive an effective wedge between the Dominion as prime borrower and the institutional purchasers of bonds. According to Towers

> ....our position versus the commercial banks and the security market is a very special one. For example, we can never obtain opinions from any outside source when we are formulating our advice to the Government regarding new issues. Thus we never enquire the views of anyone outside the bank. A central bank must be independent and impartial, which means that on most occasions it must play a lone hand.[409]

This "lone hand" effectively meant the elimination of the previous consultations or

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[407] J.A. McLeod, "Presidential Address," *The Journal of the Canadian Bankers' Association*, Volume 40. No.2 (January 1933), p. 165 and *Proceedings*, Royal Commission on Banking and Currency, Ottawa, September 1933, pp. 3155.
[408] *Central Banking after Bagehot*, (Oxford: 1957), pp. 112–113. (emphasis added). Indeed it was predicted that during the early years of the Bank's operations the moral force of the bank would be at its weakest which would be its principal source of power and influence. See testimony of M.W. Wilson on behalf of the Canadian Bankers' Association, *Proceedings*, Royal Commission on Banking and Currency, Ottawa, 14 September 1933, p. 3161 and Neufeld, 1958, p. 76.
[409] Towers Memoranda, No. 50, December 1936, "Statement Re. Mechanics of Central Banking: for Dominion–Provincial Conference, December 1936," *Bank of Canada Archives*.

negotiations with the chartered banks. The banks were never again to be permitted to participate *directly* in determining the cost of money to the Dominion. Henceforward, the Bank's policy initiatives and the Government's borrowing costs would be based on the central bank's policies in response to Government needs and the movements of domestic and international financial markets.

TABLE 5.4

Assets and Liabilities of the Bank of Canada, 1935-1952

YEAR	Gold (1)	Short Term Securities (2)	Long Term Securities (3)	Total Assets (4)	Chartered Bank Deposits (5)	Notes in Circulation (6)
1935	181.5	31.9	83.4	307.7	181.6	99.7
1936	179.4	61.3	99.1	357.0	187.0	135.7
1937	179.7	82.3	91.6	390.4	196.0	165.3
1938	185.2	144.6	40.9	404.9	200.6	175.3
1939	225.7	181.9	49.9	527.2	217.0	232.8
1940*	–	448.4	127.3	626.6	217.7	359.9
1941	200.9	391.8	216.7	842.9	232.0	496.0
1942	0.5	807.2	209.2	1048.2	259.9	693.6
1943	0.6	787.6	472.8	1308.7	340.2	874.4
1944	172.3	906.9	573.9	1687.4	401.7	1036.0
1945	156.8	1157.3	688.3	2031.9	521.2	1129.1
1946	1.0	1197.4	708.2	1948.6	565.5	1186.2
1947	1.9	1022.0	857.5	1925.2	536.2	1211.4
1948	0.4	1233.7	779.1	2058.6	547.3	1289.1
1949	74.2	1781.4	227.8	2125.9	541.7	1307.4
1950	111.27	1229.3	712.5	2350.3	578.6	1367.4
1951	117.97	1141.8	1049.3	2444.1	619.0	1464.1
1952	77.2	1459.8	767.2	2381.4	626.6	1561.2

SOURCE: *Annual Report of the Governor of the Bank of Canada and Statement of Accounts*, (Ottawa: 1936–1953).
* Early in 1940, gold was sold by the Bank to the Foreign Exchange Control Board.

The intermediary role played by the Bank as fiscal agent and debt manager put the central bank in a somewhat schizophrenic position between the securities markets and institutional investors and the Government. In 1937, this schizophrenia became evident during discussions between Dunning, Clark and Towers. Normally the central bank advanced proposals in the form of recommendations to the Minister and his officials on the term (tranches) and rates to be offered. That October, Towers recommended a 3.5 per cent bond at par which Clark felt would be "construed as an admission and crystallization of a higher rate structure, and it was too early to take any such action." In

reply, the Governor believed this rate "during the *present unsettlement in the marke* could not be construed as a definite admission of permanently higher rates."[410] Several days later, Clark suggested that if the 3.25 per cent rate proved to be a flop the Exchange Fund Account managed by the Bank might take up the residual. For Towers, this action would have had the effect of deceiving the market and "a great many people will say that the Government had got into a fix by endeavouring to pare things down too fine."[411] In Towers' view, it was essential that the loan be a complete success during this period of market uncertainty and a 3.25 per cent rate "would not sell in sufficient volume to constitute a success."

> We had feared that no more than, say, $35 millions might be taken, instead of the $50/60 millions which was probably needed.... certainly I hoped that would be the case. Our recommendation for the 3 1/2s was based on the feeling *that they give much greater certainty of success at a time when failure would be a bad thing,* and they did not represent an unreasonable cost so far as the Government was concerned.[412]

What is revealing about this discussion was the Governor's strong desire to safeguard a warm market reception for the bonds. This expectation, "the greater certainty of success", is consistent with the literature which emphasizes that Canada issues must be successful. Clark and Dunning meanwhile, from their institutional standpoint, that of the borrower, feared a possible market reaction to a higher rate which would have been detrimental to future borrowing. This is not to say that the Governor and his officials were totally indifferent to the borrower's desires for a reasonable rate for borrowing. In a memorandum prepared in May 1936, the Governor wrote:

> But what we are trying to recommend is a procedure which, in the end, will be the most satisfactory and most economical to the Government. I feel that this point is extremely important because if any impression– even a subconscious one grows up that we are casual in our attitude towards costs or possible savings, there *must necessarily be a tendency to discount any advice we may be able to give.*[413]

The central bank then, in tendering advice to the Dominion on interest rates and terms, had

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[410]Towers Memoranda, No. 72, 26 October 1937, "Memorandum of Conversations with Mr. Dunning and Dr. Clark in regard to proposed loan," *Bank of Canada Archives.*(emphasis added)

[411] Towers Memoranda, No. 74, 28 October 1937, "Re. discussions on 1937 autumn loan," *Bank of Canada Archives.*

[412]Towers Memorandum, No. 75, 29 October 1937, "Conversation with Charles Dunning," *Bank of Canada Archives* (emphasis added)

[413]Towers Memoranda, No. 19, 26 May 1936, "Considerations in regard to possible conversion loan, June 1936," *Bank of Canada Archives* (emphasis added)

to be both *realistic* in its appraisal of the market and at the same time *sensitive* to the borrower's requirements for low rates.

Funding the Debt

During 1936, attention was directed towards *funding* the debt, that is, lengthening the term to maturity. In the following passage, W.C. Clark outlined for Dunning the variables to be taken into account when determining the term to maturity structure. These variables included the direction of interest rates and tailoring the term and rates to ensure investor receptivity.

> If the objection to a 3 1/4% coupon rate is a real one with you, the alternative would be to try a 12 to 15 year issue, which we could do at slightly better than 3 % if the naturity (sic) were less than say 14 years and slightly above 3 % if the maturity were 14 or 15 years. A 12 to 15 year maturity would probably be too long to attract bank buying in any volume and it would not give a rate of return that would be attractive to the insurance companies. To make sure of the success of the issue we could combine it with a shorter issue, say a six or seven year maturity, but the objection to this is that we probably should retain as many short term maturities for use a little later when we have to refund issues maturing in a period of higher interest rates. *In other words, when the trend in interest rates turns upwards we will probably prefer to issue 3 to 7 year bonds rather than to tie ourselves up for say a 15 to 25 year period at the prevailing higher interest rates.*[414]

Clark then recommended a strategy based on the maturity structure to cope with the possibility that interest rates would begin a secular rise, a strategy which was not counter-cyclical but selfish to the extent of keeping interest expenditures to a minimum. Sensitivity to longer term, low cost financing is very evident in formulating this hedge which counselled borrowing short when rates were high and funding when rates were low.

The desirability of funding the debt at the prevailing low rates also preoccupied the Bank of Canada. In June of 1936, Towers speaking of the banks and life companies' lack of enthusiasm for long-term issues, noted:

> We believe that their resistance is breaking down and that they would be ready to accept a longer term, say 30 years, for the sake of the additional yield. It is a moot question whether they will regard a 3.30 yield as attractive; but the Government cannot, and should not, offer anything better, and the prospects for success, are, in our opinion, sufficiently good to make the attempt worthwhile.[415]

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[414]W.C. Clark to Charles Dunning, 4 February 1936, *Public Archives of Canada,* RG 19, Volume 3978, Deputy Minister's Files, File F-1-6. (emphasis added)

[415] Towers Memoranda, No. 19, 26 May 1936, "Considerations in regard to possible conversion loan, June 1936," *Bank of Canada Archives.*

This assesment laid the groundwork for another Bank initiative by the Securities Advisor, K.A. Henderson which resulted in the sale of $55,000,000 of perpetuals delivered in September 1936. In a "Very Secret and Confidential", undated memorandum authored by Clark, there was some doubt in the Deputy's mind as to the success of the proposed operation. Clark believed it would be safer to insert a hedge in the form of a 10 year, 2 per cent bond, just in case the market did not accept the perpetuals. "While I, myself, would feel more comfortable with such a hedge," Clark advised his minister, "the Bank officials are confident that the perpetual will sell readily and that a hedge is unnecessary."[416] Clark, though slightly ambivalent on the perpetual issue had confidence in the judgement of the Bank's officials and felt the initiative would meet the needs of "other financial institutions" (non-bank sector) and was consistent with "future plans for consolidation of our national debt."[417]

Broadening the Market for Dominion Debt

The main impetus for a broader distribution of the debt came from the central bank's Securities Department which had a close, daily contact with the securities market. Early in 1937, Assistant Deputy Governor Saint-Amour advised his superiors of the trials and tribulations of "the small investor (who) may put in his subscription a few times but if he is turned down on each occasion he will soon take it for granted that his money is not wanted, and will assume that Government bonds are monopolized by banks, insurance companies, etc."[418] In the 1937 *Annual Report*, it was announced that to promote wider distribution of bonds the period elapsing between the offering and the opening of subscriptions was being extended. "This procedure gives small investors, particularly those who are distant from the large centres, a better chance of participating in a new issue," the *Annual Report* commented.[419]

Behind the scenes, officials in the Securities Department promoted the idea of issuing bonds in smaller denominations. In February 1938, W.H. Budden reported a strong demand from small subscribers for a recent C.N.R. issue. Budden counselled the

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[416]W.C. Clark to Charles Dunning, "Re. Proposed Dominion Financing for $100,000,000," n.d., *Public Archives of Canada*, RG 19, Volume 3978, Deputy Minister's Files, File F-1-11.
[417]*Ibid.*
[418]"Memorandum to the Governor and Deputy Governor from Assistant Deputy Governor," 21 January 1937, *Bank of Canada Archives*, "DG-400, Dominion Government Financing, 1935-1937."
[419]Bank of Canada, *Annual Report, 1937*, (Ottawa: 22 February 1938), p. 11.

Governor "the availability of registered bonds in small denominations with the interest paid direct to the owner by cheque would not only provide an improved outlet for savings but would also have a salutary effect of developing a wider interest and support for government securities."[420] The Securities Department followed this up by calling for the issue of bonds in denominations of $100, $500, and $1,000 in registered form "to facilitate a wider distribution of Dominion of Canada long term bonds" in response to a "progressively increasing demand".[421] The foregoing should be seen in the context of discussions taking place between the banks and the investment dealers at this time in an attempt to improve the marketing and distribution of Dominion securities. (See Chapter VII) This initiative to draw in a wider group of middle class subscribers is also related to what was perceived to be a distortion in the bond market caused by certain classes of investors, including institutional investors, who had monopolized the ownership of these tax-exempt bonds.[422] Table 5.5 how that the Government was again successful in lowering the average cost of its debt and interest per capita in spite of the growth in total debt per capita.

TABLE 5.5
Unmatured Debt, Net Debt Per Capita, Average Rate, 1936-1939

Year	Funded Debt (1)	Average Interest Rate (2)	Net Debt Per Capita$Cdn (3)	Interest per capita $Cdn (4)
1936	3,207	3.94	274.53	12.29
1937	3,276	3.76	279.22	12.44
1938	3,315	3.56	278.13	11.85
1939	3,386	3.53	279.80	11.36

SOURCES: *Canada Year Book*, (1930-1953).

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[420]W.H. Budden to Governor Towers, 7 February 1938, *Bank of Canada Archives*, DG 400- Dominion Government Financing, 1938.
[421]Memorandum to the Governor from Securities Division, "Re. Desirability of Issuing smaller Denominations particularly in Registered Form," 7 February 1938, *Bank of Canada Archives*, "DG-400, Dominion Government Financing, 1938."
[422]*Ibid*, and Ralph B. McKibbin to author, 27 April 1982.

TABLE 5.6

Interest, Deficit in relation to GNE, Government Expenditure, 1936-1939

Year	Interest	Interest %Govt. Expend.	Interest % GNE Factor	Deficit % Govt. Expend.	Deficit/Surplus % GNE Factor
	(1)	(2)	(3)	(4)	(5)
1936	135	25	3.0	−8.5	−0.8
1937	137	26	2.8	+2.0	+0.2
1938	132	25	2.8	−17.9	−1.9
1939	128	23	3.2	−0.4	−0.05

SOURCES:Column (1)*Public Accounts of Canada*, for year ending March 31. Columns (2)–(4) Cansim Mini Series D 30580 (Interest), D 30591(Expenditure), D 40248) GNE at Factor Cost, *Canada Year Book*.

Obstacles- Alberta and the Banks

Unsettled market during 1935 and 1936 and the concentrated ownership of the debt continued to plague the Government over this period. One of the earliest problems which disturbed the domestic market was the Premier of Ontario's revocation of hydro contracts to four, privately-owned, Quebec based power companies. As noted in Chapter IV, this move drew the ire of the Prime Minister who calculated the annual loss to the treasury necessitated by the sudden withdrawal of its London conversion loan at $700,000 for 20 years.[423] The response of the Canada's financial community to Hepburn's action was swift and categorical. That June, when Ontario requested bids for a new bond issue, no bids were received! "So far as official records show," reported *The Monetary Times*, "this is the first time that any Ontario government which called for public tenders, has failed to receive a single bid."[424] Hepburn concluded a conspiracy had taken place and he used this boycott to announce the opening of 30 new branches of the Province's savings banks fuelling wild speculation that he was working on some Social Credit scheme.[425] Others believed that dealers simply did not bid because they were afraid of

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[423]House of Commons, *Debates*, 17th Parliament, 6th Session, 21 May 1935, p. 2924.
[424]"No bids received for Ontario," 8 June 1935, p. 20.
[425] The Province of Ontario Savings Office was established in 1921 by the United Farmers of Ontario Government as a means of providing low-cost financing to Ontario farmers. The Savings Office is still in existence with branches throughout the Province with its headquarters on Bay Street. See E.J. Doak, *Financial Intermediation by Governments*, Unpublished Ph.D. disertation, University of Toronto, Department of Economics, 1970, pp. 81–85.

being left with their hands full of unmarketable Ontario bonds.[426]

The main threat, however, to the integrity of Canada's capital markets and the Dominion's credit standing came from out west. As soon as the Bank opened its doors Graham Towers was the recipient of requests for aid from the Province of Alberta. In March, J.F. Percival, Deputy Provincial Treasurer informed Towers that a $2 million loan would not cure the situation "except by prevention of default."[427] Two weeks later, Percival wrote to Towers giving his analysis of the financial and political situation of Alberta.

> Present bond prices indicate a wave of non-confidence throughout Canada; and in the face of a decided improvement of our revenues and in practically all lines of commercial business and that of agriculture, it is, to say the least, discouraging to find that pending elections and Government action should destroy what appeared to be a very strong and stable bond market. However, I am not altogether surprised that this should take place. Most of us here are suffering from what might be called a Social Credit headache, and during the next three months anything may happen.[428]

Percival's comments were prescient. They are also an indication of the perceptions and assumptions shared by bankers and finance officials of the natural negative reaction of bond markets to political events which would upset the price of outstanding issues–prices which determined what it would cost for new money. The August 1935 election results did have a negative impact on western bonds with Alberta bond trading at a standstill. Canada bond yields rose nearly 40 basis points after the Social Credit victory but then resumed their downward path in October.

The flurry of activity in March 1936 prior to the April first default is indicative of the fear that western provincial defaults would spread and therefore a coordinating mechanism was needed to prevent the floodgates of repudiation and default from bursting open. In a letter to Towers from S.R. Noble, Assistant General Manager of the Royal Bank, the "market's" potential reaction to default was sketched:

> Unquestionably, something must be done to control the expenditures of the Provinces, but the Western ones particularly have had a very severe lesson in

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[426]*The Monetary Times*, "The Business Outlook," 22 June 1935, p. 1. According to one dealer interviewed, there was a fear on the street that Hepburn might move further to repudiate even the bonded indebtedness of the province. The decision taken by dealers not to bid for the bonds was a means of registering a protest against Hepburn's earlier action. *Interview*, 26 May 1982.

[427]Towers Memoranda, 30 March 1935, "Conversations with Mr. Percival, Deputy Provincial Treasurer, March 20–22, 1935," *Bank of Canada Archives*, PF2– Provincial Government Financing, Alberta 1935, 1936.

[428]J.F. Percival to G.F. Towers, 5 April 1935, *Bank of Canada Archives*, PF2– Provincial Financing– Alberta, 1935, 1936.

> the last few years and a default would create a serious situation and set back recovery very materially. It would, it seems to me, very seriously prejudice our reputation abroad, which we have maintained at tremendous cost.[429]

As the date of the April 1 maturity neared, Dunning drew to the attention of Alberta's Treasurer the adverse consequences of the market to political statements originating in Edmonton. On March 17th, Dunning cabled Cockcroft:

> Your letter requesting Dominion loan to assist you in meeting April first maturity reached me simultaneously with the Premier's announcement that Province was about to introduce legislation reducing interest rates on outstanding debt apparently without reference to proposed Loan Council arrangement.(STOP) *Announcement has already had serious adverse effect on market particularly for Western Provincial bonds and proposal if carried out would nullify all efforts already made and proposed to be made by Dominion to protect credit of the Provinces and the Dominion as a whole.*(STOP) In view of the action contemplated by Province, I do not see how I could justify to Parliament and to the country the loan for which you are now asking.[430]

In throwing down the gauntlet and, in effect, challenging Alberta to comply with the Dominion's desire to protect its credit-worthiness, Dunning ran the calculated risk that default would spread. In the wake of the default, Western bond prices declined while Dominion bonds held steady indicating that the calculated risk had been successful in isolating Alberta's credit from the Dominion's.[431] Towers, in reflecting on the Alberta and Western situation, perceived that "the Alberta default did not cause any important disturbance in the market for bonds of the Dominion of Canada or of eastern provinces. Even though the Minister of Finance stated that Social Credit did not have anything to do with the Dominion's decision not to assist Alberta, both foreign and domestic markets have tended to regard the Alberta situation as a very special affair."[432]

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[429] S.R. Noble to G.F. Towers, 26 March 1936, *Bank of Canada Archives,*"PF2– Provincial Financing– Alberta, 1935, 1936". These views seem to parallel those of Senator McMeans who demanded that someting be done to control the legislation of the western provinces.

[430] CN Telegram, Dunning to Cockcroft, 17 March 1936, *Bank of Canada Archives,*"PF2– Provincial Financing– Alberta, 1935, 1936." (emphasis added) See also correspondence between the Alberta Premier, Cockcroft and Dunning tabled in the House of Commons by Dunning, House of Commons, *Debates*, 18th Parliament, 1st Session, 1 April 1936, pp. 1683–1687.

[431] *The Monetary Times*, "The Business Outlook," p. 1. "The street apparently took the view that as the Dominion was not going to guarantee the province's bonds, its own credit must be strengthened thereby, while the market for Alberta bonds was weakened." In fact between March and June 1936, long term yields on Canadas fell by about 15 basis points.

[432] Towers Memoranda, No. 14, 18 April 1936, "Memorandum in regard to Loan Councils and certain alternatives to present proposals," *Bank of Canada Archives.*

In formulating alternatives on the broader question of the western province's predisposition to default, Towers recognized that default was inevitable (with the possible exception of Manitoba) unless financial assistance were made available by the Dominion. A loan council was problematic in Tower's opinion because "it would be extraordinarily difficult for Saskatchewan and Manitoba to accept a position which would be called one of tutelage at the same time that Alberta and British Columbia were acting independently." What was needed, in Towers' view, was a policy that bridled "local opinion" which called for "more of the benefits as well as the odium of default." Towers argued that the benefits of default calculated to be approximately $6.5 million in interest per annum were far outweighed by the damage to the Dominion's credit structure.

> It would be penny wise and pound foolish to allow an upset to be caused by western defaults which would not provide more than a fraction of the relief required by the country as a whole, and would, on balance, cause a loss to the country as borrowers abroad, and to the Dominion Government as borrowers anywhere. *It must not be overlooked that Dominion Government requirements for new money and refunding during the 1936-37 year are extremely large.*[433]

This underscores the Governor's understanding that provincial and dominion credit were closely linked and his sensitivity to provincialist arguments. His belief that default would collectively harm the people is reminiscent of Bennett's earlier pronouncements about credit and the character of the Canadian people. Having successfully separated Canada' credit from that of Alberta', Tower recommended a policy to the Government to safeguard the financial intergrity of the other Western province from default.

Unsettled markets in the wake of the Alberta default delayed a proposed loan in early June 1936. According to Deputy Finance Minister Clark

> The Alberta development and the worsening situation in France make it inadvisable to go ahead with the issue next week. We propose, however, to have everything in readiness in order that we may make the public offering on Wednesday next if conditions appear satisfactory on Monday morning. On Monday the French Chamber meets and the new Government takes office, and the early morning cables will give us the necessary information on which to make our decision. Prices cannot, of course, be determined definitely until that time.[434]

Note the attention paid to international political developments which dictated caution and great skill in timing an issue to avoid any predictable political events which could mean the

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[433] *Ibid.* (emphasis added)
[434] W.C. Clark to Charles Dunning, 28 May 1936, *Public Archives of Canada*, RG 19, Volume 3978, File F-1-11.

difference between success or failure.

Bond prices rallied during the summer of 1936, but at the end of August the Social Credit government brought down a series of measures which brought more nervousness to markets. These measures included a cut in interest by one half on all outstanding provincial securities,[435] and municipal securities,[436] a retroactive cancellation of all interest owed on farm mortgages since 1932,[437] and the establishment of an "Alberta Credit House."[438] That winter, the Canadian cabinet was confronted with a dilemma. Should the Dominion rescue what some, including King, felt to be an impossible situation by pouring in "good money after bad" or permit Saskatchewan and Manitoba to default? As Towers stressed earlier, the "generosity" of the Dominion was necessary to ensure the very success of the refunding operations during the coming fiscal year. According to Professor Neatby:

> Charles Dunning, who had shown so little sympathy for provincial administrations a year before, had now shifted his ground because as Minister of Finance one of his major responsibilities in 1937 would be refunding of more than three hundred million of federal bonds. He hoped to sell the new issues at 3 per cent instead of the 5 per cent or higher on the maturing issues, for an annual savings of some six million dollars, but much depended on the credit rating of the federal government at the time. He preferred not to have provincial governments defaulting while he was refunding the federal debt.[439]

Indeed, by the beginning of 1939, the Dominion had advanced to the Western provinces some $100 million in direct relief and grants in aid to keep the western provinces (Alberta excepted) afloat by ensuring that interest and principal payments would be made.[440]

Limiting the Banks' Influence

Bank of Canada documents support the thesis that leverage exercised by the banks was founded upon their vast holdings of *maturing* government paper. The creation of a central bank was seen as a partial wedge by which to give the Government more flexibility in refinancing. This could be done by eliminating negotiations and also via larger central

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[435] *The Provincial Securities Interest Act,* 1 Edward VIII (Second Session), Statutùes of Alberta, 1936, Chapter 11.
[436] *The Municipal Securities Interest Act,* 1 Edward VIII, (Second Session), Statutes of Alberta, 1936, Chapter 12.
[437] *The Reduction and Settlement of Debts Act,* 1 Edward VIII, (Second Session), Statutes of Alberta, 1936, Chapter 2.
[438] *The Alberta Credit House Act,* 1 Edward VIII, (Second Session), Statutes of Alberta, 1936, Chapter 1.
[439] Neatby, 1976, p. 197.
[440] Figures cited in Budget Speech, 25 April 1939, House of Commons, *Debates,* 18th Parliament, 5th Session, p. 3173.

bank holdings which would reduce the relative market holdings of the "Big Four" or "Big Five". Indeed a new game plan was prepared– no "negotiations" . As Towers declared at the Dominion–Provincial Conference in December 1936, "we never enquire the views of anyone outside the bank. A central bank must be independent and impartial, which means that on most occasions it must play a lone hand."[441]

Chartered banks' holdings of dominion and provincial stock grew rapidly between 1935 and 1939 nearly doubling to $1,234 million.[442] From the Bank's perspective it remained a slow and arduous process to break institutional behaviours developed over one half a century or more of negotiating the terms of loans. Below are cited several instances in which the banks' holdings were viewed as a major obstacle in refinancing.

In a memorandum dated 4 February 1936 and presumably authored by K.A. Henderson, the head of the Securities Department writes:

> Of the remaining items the most important are $45,000,000 Dominion of Canada 1 1/2% bonds due 15th September 1936, $63,336,000 Dominion of Canada 2% bonds due 15th October 1936, and $79,535,200 Dominion of Canada 5% bonds due 15th November 1936. These maturities total roughly $188 millions and it can be taken for granted that possibly $150 to $160 millions are held by the chartered banks in Canada. The Government is, therefore, in the position of having to deal at maturity with the banks in a refunding arrangement which might be contemplated at that time. *(The experience of last year in similar circumstances was not one which we would particularly like to have occur again.)* [443]

In May 1936 Towers observed that "it would be necessary to have indications from the banks that the terms of the offering were such that they would convert the bonds held by them. While we should not assume that their views would be definitely unreasonable, they might differ from those of the Government by an amount which would not be sufficient to give grounds for a quarrel, but which easily might add to the Government's cost of financing by an amount of, say, 1/20th of 1%."[444] "If the offering is made on a pure conversion basis," Towers continued, "I am afraid that the results might be unsatisfactory. For one thing, as the banks hold a substantial majority of the maturing bonds, *might they not expect that the Government would sound them out on terms before*

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[441]Towers Memoranda No. 50, December 1936, "Statement re. Mechanics of Central Banking: for Dominion–Provincial Conference, December 1936," *Bank of Canada Archives.*
[442]*Canada Year Book*, 1946, pp. 963–964. (Figures average of banks' monthly reports).
[443]"Dominion Government Financing Fiscal Year 1936–37," *Public Archives of Canada*, RG 19, Volume 3978, File F–1–6.(emphasis added).
[444] Towers Memoranda, No. 19, 26 May 1936, "Considerations in regard to possible conversion loan, June 1936," *Bank of Canada Archives.*

proposing a conversion; and would a failure to do so set up a resistance on their part?" [445] In December 1938, the issue of conversion was broached at a meeting of the Governor and a committee of the CBA. Towers referred at that meeting to the Government's "painful experience" in the autumn of 1935 when "faced with the immediate necessity of refunding a relatively large issue, practically all of which was in the hands of the banks."[446]

A further example of the enormous market wielded by the banks is revealed in correspondence between the General Manager of the Bank of Montreal and the Minister of Finance, Charles Dunning in October 1936. The correspondence shows the Bank of Montreal presented for conversion during the June loan $44,000,000 or almost one-third of the total conversion offer! In bringing this to the attention of the authorities, Dodds was seeking preference for subscibers "paying for the new issue by surrendering the old."[447] What Dodds wanted, simply stated, was preferential treatment from the Government for the half dozen large holders of maturing debts who wished to be able to convert their holdings into the tranche which most closely suited their needs and not the needs of the issuer refunding the bonds. Dunning's response suggests the banker's preference for bigger proportions issued at the short end of the market was not well received. Dunning, in replying to the Montreal's General Manager, stated "we feared that preferential allotment on preferred subscriptions *would make it necessary to issue a larger proportion of short term bonds than we thought desirable."*[448]

In April 1937, discussions on a possible refunding loan were held with the Minister, Clark, Deputy Governor Osborne, Henderson, the Securities Advisor, and Towers. Towers "pointed out the strong position of the banks as holders of the great majority of the maturing bonds, and said that we thought a 3 1/2 per cent new long term issue would be necessary to attract buyers and *promote redistribution.*"[449] Towers added

> We did not want to make *a direct arrangement with the banks, in view of the probable costs involved;* yet a refunding offer now, containing only banking maturities, would not work. At the worst, it might be dressed up with a longer term offering to get away from the suspicion of an issue designed for banks

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[445] *Ibid.* (emphasis added)
[446] "Comments on report of meeting with C.B.A. Investment Committee," 21 December 1938, *Bank of Canada Archives,* "DG 400– Dominion Government Financing, 1938".
[447] Jackson Dodds to Charles Dunning, 28 October 1938, *Public Archives of Canada,* RG 19, Volume 589.
[448] Dunning to Dodds, 31 October 1936, *Public Archives of Canada,* RG 19, Volume 589. (emphasis added).
[449] Towers Memoranda, No. 54, "Memorandum regarding conversations on Dominion refunding, April 1937," *Bank of Canada Archives.*

but on which they were not consulted.[450]

As a result of these discussions it was decided to go ahead in May with an offer in three tranches with two banking issues (a 2 year and 5 year issue) totalling $80,000,000 and a 12 year tranche accounting for $33,500,000. This offering was indicative of the difficulty the Government still faced in trying to refund the debt which was largely in the hands of the chartered banks. In another instance during May 1938, Henderson in a memo to Deputy Minister Clark stressed the "formidable" financing requirements which were "rendered more difficult because of the distribution of $90 million 2% bonds due October 15th". Henderson estimated that over $70 million of the bonds were held by the major banks.[451]

The foregoing serves to emphasize the enormous market influence of the banks at the "short end" of the market. It also shows the constraints the new Bank of Canada laboured under when it came to arrange a re-financing operation given the banks' obvious desire and past behaviour to be consulted over a "roll-over" operation. One of the ways in which this market power of the banks was weakened was the central bank's technique of advance refunding a maturing issue by "being in the market" for bonds which were maturing in the near future.[452] This could be also be achieved by "switching", that is, by selling long-term bonds from its portfolio in exchange for the maturing issue. This process produced a situation in which perhaps one-half of the maturing issue was in the hands of the central bank thus reducing the need to worry about the banks' intentions.

From the banks' perspective, consultations removed uncertainty as to price and also permitted the bankers access to official-level thinking about the trend in rates and the Government's cash requirements. This close relationship pointed to the need for some institutional mechanism by which the Government would be able to distance itself from the chartered banks. It was also felt a restructured relationship would tend to lower interest costs to the Government through such mechanisms as the weekly treasury bill aùction and the establishment of a broader and more competitive market for financial instruments especially Dominion of Canada bonds.

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[450] *Ibid.* (emphasis added).
[451] K.A. Henderson to W.C. Clark, 10 May 1938, *Public Archives of Canada*, RG 19,, Volume 3978, File F-1-6.
[452] *Submissions by the Bank of Canada to the Royal Commission on Banking and Finance*, 1962, p. 48.

September 1939 - December 1945

Well before war was declared on September tenth, the Bank of Canada had been working on a system of exchange controls in the event of war. Foreign exchange controls were established on 15 September 1939.[453] In anticipation of a shortage of U.S. currency, the Bank's open market operations had been directed during the months leading up to war to the purchase of optional payment securities with a view to reducing the nation's requirements for U.S. dollars.[454] In September, a Working Committee composed of bankers and dealers was established to investigate the possible methods of raising loans. During 1940, a War Savings Committee and the Dominion War Loan Committee were created to oversee the sale of savings certificates and war loans respectively. The first organization was responsible for the sale, *on a continuing basis*, of savings stamps and certificates in small denominations, while the latter group was responsible for the organization and marketing of the large war loans over a three week period every Spring and Autumn. In March 1942, the two groups merged to become the National War Finance Committee under the chairmanship of G.W. Spinney, General Manager of the Bank of Montreal.

The main objectives of the Bank, the Finance Department and the National War Loan Committee were firstly to finance the war at as low a cost as possible and secondly, to ensure a wide distribution of the debt thereby minimizing reliance on the banking system (including the central bank) and avoiding the inflationary consequences of such borrowing. The goal of achieving as wide a distribution as possible of the national debt was associated with the need to (1)mobilize the large volume of idle bank deposits in the hands of individuals and corporations[455] and (2) to restrict consumption *by voluntary methods* to ensure that all the physical resources required were made available to the war machine being put in place under the leadership of C.D. Howe, Minister of Munitions and Supply. The main obstacles faced were the unwillingness of consumers to provide their dormant and current savings to the Government which forced the Government to rely heavily on the central bank for its war related purchases and in 1942 to borrow from banks at below

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[453]P.C. 2716, 15 September 1939 which promulgated a system of exchange controls which required chartered banks to act as agents of the Crown.
[454]*Interview*, 1 June 1982.
[455]W.A. Mackintosh, "Budget Considerations," 9 May 1940, *Public Archives of Canada*, RG 19, Volume 3551, p. 4.

market rates. Curiously, the resolution of these difficulties was similar to proposals advanced by Social Credit members– the issuance of legal tender by the central bank and informal limits placed on the chartered banks' abilities to write commercial loans on their expanded cash reserves. The operationalization of this method through the issue of Deposit Certificates to the banks will be the subject of more intensive discussion in the next chapter.

Objectives

Low Interest Rates

Clark was unequivocal on the question of financing the war at low rates of interest. In a memorandum dated 5 September 1939, Clark, estimating a deficit in the neighbourhood of $100,000,000 for fiscal 1939–40, underlined the absolute necessity for a massive reorientation and reorganization of the tax system. Clark also wrote of the need

> to retain confidence and enable the huge borrowing operations which we will be compelled to proceed with to be carried out at reasonable interest rates------*and by reasonable rates I not not mean anything like the interest rates which prevailed during the last war.* We will have to keep effective control of our capital market, but to maintain such control many devices will be necessary and in addition we will need to show the investing public that we take a most serious view of the real sacrifices which must be made by the Canadian public in the form of tax levies.[456]

For Clifford Clark, low interest rates were not a matter of "public opinion" or politics, but a matter of necessity if Canada was to end up after the war in a financially secure position. Hence, the deputy minister resisted all movements which portended the crystallization of rates at a higher level.[457] In September 1939 during a meeting with life insurance executives, Clark declared "a four per cent rate would create a revolution in this country."[458] Clark was never loathe to use political considerations when it came too arguing the case for lower interest rates.

The achievement of lower rates of interest was the subject of a memorandum prepared by the Toronto investment dealer, Stanley Nixon who was on the National War Finance Committee. In Nixon's view "a favourable market background for public

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[456]W.C. Clark to J.L. Ilsley, 5 September 1939, "Re. War Budget and Financial Policy," *Public Archives of Canada*, RG 19, Volume 3427, pp. 3–4. (emphasis added)
[457] *Interview*, 11 June 1982.
[458]W.C. Clark to J.L. Ralston, 18 September 1939, *Public Archives of Canada*, RG 19, Volume 3978, File F–1–11, (Deputy Minister's Files)

borrowing operations" was required "to keep long-term rates at or below current levels." This favourable market background could be achieved in Nixon's mind

> If investors, particularly the "professional" groups, develop confidence in the intention and ability of the government to hold long-term rates around a 3 % level, some portion of the current demand for short and medium-term issues will be withdrawn, and some holdings of these issues will be sold, in favour of higher yielding long term securities.[459]

Nixon's statement underscored the market's need for assurances from "official sources" that medium term interest rate policies would favour the purchase of longer term instruments that would hold their value. Nixon's memo also indicated the existence of an important trade-off between the objectives of funding the debt at higher interest rates versus interest rate minimization through shorter-term issues.

Towers, as late as the summer of 1944, had "no qualms" about the Bank's and Dominion's capacity to carry out a cheap money policy consistent with maintaining par for the 3 % Victory Bonds. The Governor felt certain that the commitments made to the millions of small investors could be kept. "In other words," the Governor wrote, "if need arises, we can see that the cash position of the banks is such that they (the banks) will, over a period, be ready buyers of securities."[460] In the event of such an emergency, the Governor recommended a bold policy with the Bank and Government buying bonds "up to whatever amount is required."[461] It was therefore apparent the central bank was pledged by war's end to an expansionary monetary policy and to the defence of that policy by stablization actions in the bond market. These commitments limited the Bank's open

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[459]S.E. Nixon, Memorandum, "Tap Bonds," 2 January 1942, *Bank of Canada Archives*, "DG 400- Dominion Government Financing, 1942-1944."

[460]G.F. Towers to J.L. Ilsley, 27 June 1944, *Bank of Canada Archives*," DG 400-Dominion Government Financing, 1942-1944." In a letter dated 10 May 1944 to Mr. C.A. White of Vancouver this policy was confirmed. Towers did not anticipate a large sell-off of Victory Loans after the war. If there was a great deal of unemployment and selling outpaced institutional buying, Towers gave assurances that: "Under such circumstances, however, the Bank of Canada would normally want to engage in open market operations in order to promote an expansion of credit. There should, therefore, be no difficulty in absorbing such Victory Bonds as people may need to sell." *Bank of Canada Archives*,"220-25- PostWar Reconstruction and Relief 1944".

[461]*Ibid*. Clark also shared this view. In a letter to Ontario's Deputy Provincial Treasurer Chester Walters Clark did not see how it was administratively possible to guarantee that marketable bonds could be sold and bought at par which had been suggested by the C.C.F. He went on to reiterate his belief that bond prices would remain stable, adding "we believe also that post war conditions are not likely to be such as to justify a rise in interest rates; if I believed that potential demand for capital and savings was going to press heavily upon the supply of capital or savings, I would be far less worried about the dangers of unemployment than some people appear to be." W.C. Clark to Chester Walters, 30 October 1944, *Public Archives of Canada*, RG 19, Volume 3978, File F-1-11, "Deputy Minister's Files."

market operations in the early post–war period to the defence of a 3 per cent long–term interest rate which gave debt managers little manoeuveurability.[462]

There can be little doubt that this goal of lowering interest rates was achieved during the War. In 1939, the average rate of interest on the national debt was 3.53 per cent. By 1945, the average rate had declined to an historic low of 2.58 per cent increase in the outstanding debt.[463]

TABLE 5.7

Unmatured Debt, Net Debt, Average Rate, 1940-1945

Year	Funded Debt (1)	Average Interest Rate (2)	Net Debt Per Capita$Cdn (3)	Interest per capita $Cdn (4)
1940	3,696	3.42	287.43	11.36
1941	4.372	3.12	317.08	12.10
1942	5,865	2.96	347.11	13.30
1943	7,893	2.66	523.44	15.96
1944	12,359	2.60	731.63	20.27
1945	15,712	2.58	935.91	26.32

SOURCES: *Canada Year Book*, (1940–1946).

Distribution of the Debt

In the *Report of the Working Committee, Dominion of Canada War Financing* the "desirability and necessity for the widest possible distribution of the issue to the individual buyer from one end of the Dominion to the other," was promoted.[464] The Working Committee underlined the "vital necessity that the first loan should be an outstanding success."[465] Predictably, the Committee composed jointly of bankers and dealers, called for "adequate compensation" to ensure the success of the enterprise.[466] This view was shared by most of the officials involved including Towers who recommended that a "broad national organization must be created to ensure that all Canadians who are financially able to subscribe to War Loans shall be directly approached."[467]

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[462] *Interview*, 1 June 1982.
[463] See A.E. Buck, *Financing Canadian Government*, (Chicago: 1949), p. 176.
[464] 24 November 1939, *Public Archives of Canada*, RG 19, Volume 604, File 155–75, p. 9.
[465] *Ibid.*
[466] *Ibid*, p. 14.
[467] Towers Memoranda, No. 368, 20 November 1940, "Re. War Loans," *Bank of Canada Archives*.

Wider distribution was deemed essential in the achievement of the twin goals of reducing unnecessary consumption and limiting bank financing. Mackintosh in his "Budget Considerations" recommended that in the event that "inflationary indications should develop, the Dominion should be ready to restrict the volume of purchasing power by "over-borrowing", i.e. borrowing from the public to pay off obligations to the banks (pending legislative action to increase taxation)."[468] By the end of December 1941, however, it had become obvious that the Government's reliance on bank financing– particularly the expansion of Treasury bills and Treasury notes had to be stopped. George Spinney, Chairman of the National War Finance Committee urged his fellow bankers to bring small investors into the market for Victory Bonds. "There is," remarked Spinney, "a limit to what we can get out of the institutions and individuals in the Special Names group and it seems to me that the limitations are even more definite on what the Government can expect to borrow from the medium-salaried class."[469] Spinney then went on to state

> As large holders of Government bonds it is in the interest of the banks that as many people as possible throughout the length and breadth of the country should have a stake in the Government debt, even though the individual holdings are not on a large scale. It is sometimes difficult to get the public at large to realize that any development which might harm the investment portfolio of banks and insurance companies is against their own interests. It is less difficult, however, to convince a man that his own intersts are imperilled if some move is on foot which might affect the worth of a War Savings Certificate or Bond which he has in his own bureau drawer or safety deposit box.[470]

What was proposed, therefore, was a campaign to sensitize the public to the dangers of too heavy bank financing was therefore developed– the very reverse of chartered banks' investment policies during the proceeding decade! Underlying this move was the realization that a widely distributed debt would be helpful in maintaining the value of the banks' bond portfolios. Wider distribution could constrain the Government in pursuing a high interest rate policy for fear of alienating the millions of Canadians whose bondholdings would be depreciated. In other words, a wider distribution was protection for the banks against sudden bond price fluctuations. In order to lessen reliance on bank financing, the chartered banks' aid was enlisted. The C.B.A. President urged bank

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[468] 9 May 1940, pp. 6–7, *Public Archives of Canada*, RG 19, Volume 3551

[469] A.W. Rogers to General Manager, The Bank of Nova Scotia, 12 December 1941, Confidential enclosure, entitled "The National War Finance Committee and the Chartered Banks" dated 9 December 1941, to "Memorandum of a Meeting in Ottawa on Thursday, December 11,1941 at 1 a.m. in the Office of G.W. Spinney," *The Bank of Nova Scotia Archives*, Secretary's Department Papers 1, File 65, pp. 3–4.

[470] *Ibid.*

managers to recommend the purchase of Victory Loans. If consulted "it would be your duty to commend it without hesitation."[471] However, there was some resistance among branch managers to recommend the purchase of bonds for branch managers saw deposits disappearing from their branches. This led to the preparation of a booklet by the National War Finance Committee in 1942 on "The Role of the Chartered Banks in War Finance" which spelled out for these bankers the manner by which deposits withdrawn to purchase Victory Bonds soon found their way back into the banking system through government deposits with the chartered banks and expenditures on goods, services, salaries, and, of course, interest.[472]

Another technique used to ensure a wider distribution of the loans was the heavy use of advertising with very strong appeals to patriotism and conscience. A typical advertisement which ran in papers during 1943 noted

> You know that it *is* possible for this war to go on and on. But you also know that buying Victory Bonds now.... buying and buying and buying them as you never did before..... is the best way you can help to bring the boys back home *sooner*. Don't let it be on your conscience!

Other ads included a sketch of Adolf Hitler kicking a chair after reading that Canadians had once again oversubscribed to another Victory Loan. The underlying theme of other advertisements suggested that those who did not subscribe were helping the Axis win the war.

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[471]C.B.A. President Jaffray to General Manager H.D. Burns, The Bank of Nova Scotia, 12 April 1941, *The Bank of Nova Scotia Archives*, Secretary's Department Papers 1, File 64, "Victory Loan 1941."

[472]*Public Archives of Canada*, RG 19, Volume 593, File 155-30-2.

TABLE 5.8

Distribution of Debt by Holder, 1938-1945

Year	Central Bank	Govt Acct.	Chartered Banks	NonRes.	Insurance Cos.	Trust Cos.	Non-Marketable Debt
1938	4.20	3.67	17.69	32.54	10.59	.62	-
1939	4.98	3.00	20.65	30.42	10.64	.67	-
1940	10.92	1.70	17.33	24.36	10.80	.63	.50
1941	9.97	2.19	19.22	18.28	11.47	0.71	1.80
1942	12.12	2.52	21.35	11.97	10.96	0.65	2.02
1943	10.97	4.36	21.91	8.76	10.40	0.73	1.83
1944	10.21	5.13	21.57	9.42	10.35	0.81	1.62
1945	10.54	4.70	20.06	6.54	10.36	0.92	1.40

SOURCES:*Bank of Canada Review, Bank of Canada Statistical Summary*, various years.

TABLE 5.9

Interest, Deficit in relation to GNE, Government Expenditure, 1940-1945

Year	Interest	Interest %Govt. Expend.	Interest % GNE Factor	Deficit % Govt. Expend.	Deficit/Surplus % GNE Factor
	(1)	(2)	(3)	(4)	(5)
1940	129	19	2.7	−14.0	−2.8
1941	139	11	2.4	−1.8	−0.4
1942	155	8	2.2	−46.1	−21.3
1943	189	4	2.7	−44.6	−21.3
1944	243	5	3.1	−51.3	−27.6
1945	319	6	4.0	−42.8	−19.3

SOURCES:−Column (1) *Public Accounts of Canada*, for the year ending March 31, various years. (Columns (1), (5)− millions Canadian dollars)
Columns (2),(3), (4), Cansim Mini Series identifiers: D 30580 (Interest), D30591 (Expenditure), GNE at Factor Cost *Canada Year Book*.

Groundwork Established for Canada Savings Bonds

It was during the Second World War that suggestions for a savings instrument which could be cashed on demand were mooted. In Chapter IV it was shown that in Parliament, the C.C.F. and the Social Credit went on record as favouring such an instrument which permitted the holders to sell the bond without a capital loss when cash was required. Early in 1940, W.A. Mackintosh, Queen's University economist and Special Assistant to W. Clifford Clark, recommended the development of a special registered bond for smaller savers. Mackintosh's analysis, prepared for Clark, favoured the creation of a debt instrument with a *definite maturity date* which could be cashed at an earlier date

in case of definite need.[473]

Later, E. Fricker, Chief of the War Savings Division of the Bank of Canada, proposed the issue of a tap bond for a term of 10 to 15 years to yield about 3 per cent. The bond would be *non-transferable, taxable,* and redeemable on a sliding penalty scale[474] This tap issue would also offer an important outlet for current savings *between* Victory Loan issues. However, the proposal was rejected on the grounds that the overhead registration costs were too high for the anticipated sales making the whole venture uneconomical. While these suggestion were shelved for the time being, the enormous success that greeted the payroll savings plan towards the end of the war assured its continuation in another form after the war. The object was to "get as many people as possible to maintain the scale of their present pay deductions."[475] The maintenance of this form of predictable savings was also viewed as an anti-inflationary measure, a method of keeping latent purchasing power in the form of savings, not consumption.

Was the Government successful in marketing its debt to a broad segment of the population? Canadian subscriptions ran to more than three million on four separate loan campaigns, representing sales to more than one quarter of the Canadian population. In Canada, the probability that an individual would subscribe to a Victory Loan was twice that found in the United States whose Government placed more of its debt with the banking system. Still, an analysis of the Special Names Canvass shows that an infinitesimal proportion of subscribers purchased the bulk of the debt. For example, Table 5.10 indicates that only 7,787 subscribers accounted for about two-thirds of the Second Victory Loan. Only 5,700 of 3,178,275 subscribers to the Eight Victory Loan purchased nearly fifty per cent of the securities issued. Typical of these big purchasers were the Canadian Pacific Railway ($15,000,000), the Canada Life Assurance Company ($12,000,000), the T. Eaton Company ($5,500,000), Metropolitan Life ($22,000,000) and the Ford Motor Company ($6,000,000) during the Fourth Victory Loan campaign.[476] Hence the claims made by the Social Credit Members of Parliament to the effect that one-third

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[473]W.A. Mackintosh to W.C. Clark, 21 March 1940, *Public Archives of Canada*, RG 19, Volume 3581, File N-01.
[474]E. Fricker to David Marble, Secetary of the Bank of Canada, 9 January 1942, *Bank of Canada Archives*, "DG 400- Dominion Government Financing 1942-1944."
[475]W.E. Scott for G.F. Towers to S.M. Wedd, President, Canadian Bankers' Association, 17 July 1945, *The Bank of Nova Scotia Archives*, Secretary's Department Papers 1, File 72, "Ninth Victory Loan."
[476]*Public Archives of Canada*, RG 19, Volume 4366.

of one per cent owned 60 percent of the debt were not as far fetched as they seemed at first blush. However, it should be remembered that life insurance companies and other financial intermediaries were acting as salaried trustees in their role as investors of depositors or annuitants' funds. Indeed large financial intermediaries were expected to be heavy purchasers of these instruments if the loan campaign was to be a success. In many ways, the strength of the special names canvass set the tone for the whole campaign, there being some concern expressed that the publicity surrounding these large subscriptions was detrimental to the campaign directed at smaller savers who felt their money was really not needed. Another dimension of the distributional question was the regional breakdown of sales. Ontario and Quebec being the home of the major financial institutions and Canada's *haute bourgeiosie* accounted for 46.8 and 28 per cent of total sales, respectively.

In general, the war loan organization was definitely successful in that it widened the distribution of the debt to millions of Canadians in small amounts who had never known what a government bond looked like before. Whereas in World War I, ten of thousands of Canadians purchased war bonds, in the Second World War *millions* bought Victory bonds. Paradoxically, the wide placement of the debt in the hands of a financially unsophisticated public which did not understand the price fluctuations of bonds, proved to be a thorny political problem in the post-war period. This was less so in the United States where institutions which lacked the vote were the major holders.[477]

In assessing the success of the Bank's and Government's attempts to minimize their dependence on the banking system, it becomes clear that the securities holdings of the chartered banks were maintained at pre-war levels while the Bank of Canada's holdings grew very rapidly. Debt held by the banking system grew from 22 per cent in 1939 to 30 per cent at the end of 1945. The Bank of Canada's short-term assets rose from $181 million in 1939 to $1,157 millions in 1945 and its long-term securities portfolio grew twelve times over the same period. Overall assets increased over 400 per cent.[478] Chartered banks' assets doubled over war-time while their holdings of dominion securities

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[477]Clarence Barber," Review of Post-War Monetary Policy," in Cairns and Binhammer, 1965, p. 213.

[478]*Annual Report of the Governor of the Bank of Canada and Statement of Accounts*, (Ottawa: 1939-1946). In 1940 a swap was "arranged" by Towers to sell to the Government $300 million in gold in exchange for a $300 million treasury bill, the proceeds of which were advanced to the Foreign Exchange Control Board.

rose by two and a half times. Commercial lending was curtailed, there being a moderate 15 percent increase in the loans written by the chartered banks. The Bank of Canada restricted the growth of commercial loans in spite of a doubling of the banks' cash reserves and a fivefold increase in its notes in circulation which normally would have formed the basis of a ten-fold expansion of bank credit. (See Table 6.2) The anomaly is explained, curiously enough, by the adoption of a policy of forced loans to the banks concomitant with the restriction of commercial lending. This approach, akin to the Social Credit's 100 per cent reserve proposals advocated selling debt to the central bank, the issuance of "national currency" and the freezing of bank credit expansion to forestall inflation. The central bank, by compelling the banks to hold low interest bearing, non-transferable, deposit certificates accomplished the twin objectives of monetizing a fair portion of the debt (about ten per cent) and restricting the growth of bank credit deemed to be inflationary.

TABLE 5.10

Victory Loan Results

LOAN	Individual Subscribers	Applications $thousands	Special	Names Subscribers	Special Names $thousandsTotal Subscribers	Total Sales $thousands
1st Victory	959,030	$313,984	9,229	$522,837	968,259	$836,820
2nd Victory	1,673,480	$335,638	7,787	$661,069	1,681,267	$996,707
3rd Victory	2,024,718	$374,614	7,436	$616,775	2,032,154	$991,389
4th Victory	2,661,068	$529,500	7,352	$779,217	2,668,420	$1,308,717
5th Victory	3,025,357	$642,136	7,694	$928,718	3,033,051	$1,570,584
6th Victory	3,070,601	$641,461	6,522	$763,552	3,077;123	$1,405,013
7th Victory	3,320,580	$801,766	6,735	$858,140	3,327,315	$1,659,906
8th Victory	3,172,575	$831,920	5,700	$731,699	3,178,275	$1,563,619
9th Victory	2,941,560	$1,221,342	6,076	$801,132	2,947,636	$2,022,474

SOURCE: National War Finance Committee, *Statistics and Information*, 1945.

Obstacles

Inflation

The main obstacle facing the debt manager during the war was the bogeyman of inflation which was, in the eyes of policy-makers, essentially a function of heavy bank borrowing. In this section the administration's approach to this problem will be documented.

Officials and Ministers were consistent in their view that the war could be financed employing three methods: inflation, borrowing, or taxation.[479] By positing the question of war finance in this way, the two alternatives were effectively reduced to two- borrowing

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[479]Donald Gordon, "Some Currents Problems," *The Journal of the Canadian Bankers' Association*, Volume 47, No. 4 (July 1940), p. 427 and J.L. Ilsley, House of Commons, *Debates*, 18th Parliament, 6th (War) Session, 12 September 1939, pp. 137-138 in which the "pay-as-you-go as far as practicable" policy was outlined.

and taxation. In November 1940, Clark pressed his Minister for a firm commitment to a programme of "drastic taxation" in the upcoming budget based on the need to offset the inflationary consequences of bank borrowing.

> If such a program is followed, we will be able to argue that it will offset the inflationary influence of short-term financing, and the short-term financing can be justified by the technical considerations (I mean the undesirability of offering a public loan immediately before an income tax payment date, the desirability of concentrating on one large public loan a year when the co-operative plan of organization is being followed, etc.) and by the need of expanding bank deposits to provide the additional working capital required by the rapid expansion of business activity.[480]

In other words, the Government needed a reason for justifying higher taxes and the inflationary potential of bank borrowing was the bogeyman used.

After the rapid inflation experienced between March 1941 and September 1941, the Government launched a campaign to sensitize the public to the dangers of bank borrowing and the necessity of a broadly based loan campaign. In August of 1942,Clark addressed a meeting of the National War Finance Committee and representatives from various labour organizations. The Deputy Minister praised the approach taken by Ilsley (on Clark's recommendation) of high taxes saying "it would have been easier for Mr. Ilsley to follow the practices of medieval kings and issue new money or borrow from chartered banks or from the Bank of Canada. But, Mr. Ilsley took the hard way because he had a conscience."[481]

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[480]W.C. Clark to J.L. Ilsley, 16 November 1940, *Public Archives of Canada,* RG 19, Volume 3978, File F-1-11, (Deputy Minister's Files).
[481] Reported in *The Globe and Mail*, "Editorial: A Profitable Conference," 4 August 1942.

Table 5.11

Bank Borrowing, 1939-1945

Creditor	Description	Date of Issue	Amount Cdn.	$Millions
Chartered banks	Two year Notes	16 October 1939	200.00	
Bank of Canada	Five year bonds	1 March 1940	64.04	
Chartered banks	Five year bonds	1 March 1940	40.96	
Bank of Canada	One year Notes	1 May 1940	250.00	
Chartered banks	2 1/2 year Notes	2 January 1941	250.00	
Bank of Canada	Second VictoryLoan	June 1941	92.80	
Bank of Canada	Two year Notes	15 April 1942	100.00	

SOURCE: *Public Accounts of Canada*, (Ottawa: 1939-1945).

At about the same time, the National War Finance Committee produced a booklet for the chartered banks entitled "The Budget and You- How Your Taxes and Savings Help to Win the War." It was ostensibly designed to "clear up much misinformation on the subject of war finance and *to promote clearer thinking on the principles of governmental borrowing.*"[482] This document advanced the Government's preference for borrowing from current and "dormant" savings with a final resort to the banks and in the last instance to the central bank. Another publication issued several months later drew a similar picture of the dangers of bank borrowing, so much so that George Spinney wanted the booklet withdrawn thinking certain sections of the text were overdramatized. [483]

The generation of publicity and propaganda by agents of the Government attempted to mould public opinion against bank borrowing. This activity was consistent with the view that inflation was solely a monetary phenomenon and could not be resisted under the mechanisms of central banking control then in existence, such as control over the banks cash reserves which the Social Credit had advocated. This policy was also congruent with the drive to soak up idle funds through the Victory Loan campaigns and

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[482](Ottawa: August 1942), *Public Archives of Canada*, RG 19, Volume 3978, File 155-30-2. (emphasis added)

[483]National War Finance Committee, "Dollars and Sense- How Our Taxes and Savings Help to Win the War," (Ottawa: 1943), *Public Archives of Canada*, RG 19, Volume 3978, File 155-30-2.

through taxation. The 1939 to 1945 period therefore is interesting in the sense that the inflation myth of bank borrowing was perpetuated at the very time when central bank actions (a fivefold increase in the notes in circulation) would normally lead to the bout of inflation feared by the publicists of this myth. However the action taken by the central bank to restrict the commercial banks lending activities played a key role in preventing inflation from getting out of hand as well as keeping down the rate of interest through its liberal debt monetization programme. It might also be remembered that the identification of bank borrowing and inflation took place at a time when the Social Credit was attacking the government on the issue of bank borrowing and the C.C.F. demanding low interest loans. These pressures lent some credence to the Bank and Governnment's position during negotiations which played on the bankers' fears of nationalization and monetary experimentation. The Government could legitimately claim that its proposals, though not what the bankers had in mind, were infinitely more hospitable to Finance than the ideas of the monetary reformers.[484]

1946-1952

In the immediate post-war period, there was considerable fear amongst politicians, policy-makers, and the public of a return to the high pre-war levels of unemployment. The lowering of the Bank Rate in February 1944 was a signal the Bank was prepared to continue its cheap money policy which was also designed to make the servicing of the national debt more manageable.[485] This policy proved to be futile as market developments emanating from both domestic and external sources eventually forced interest rates upward. Specifically, these forces were rising rates in New York and the rush by Canadians to sell Victory Bonds to finance houses and consumer durables. The action taken by the Bank during 1947 in relation to these pressures was to buoy up bond prices. Such a policy was predetermined by policy statements made by the Governor and the

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[484] In response to the perceived threat of the C.C.F. and the Social Credit the Canadian Bankers' Association published a tract by W.T.G. Hackett called *A Background on Banking Theory*, (Toronto: 1945). which sought to discredit ideas about nationalization and inflation.
[485] In January 1945, a Bank of Canada memorandum "For internal guidance" promulgated "a policy which will ensure marketability and stability". Towers Memoranda, No. 480, 8 January 1945, *Bank of Canada Archives*. This policy was consistent with similar statements issued by U.S. and U.K. authorities.

Minister during wartime to the effect that small savers would be shielded from falling bond prices. These unwritten, unlegislated commitments proved to be powerful obstacles to the development of a monetary policy aimed at combatting inflation and limiting the expansion of bank credit. Though the Bank's easy money policy was consistent with the goal of interest rate minimization, actions to keep bond prices high tended to fuel speculation on the course of future interest rates as unsettled markets anticipated changes in policy to conform with movements south of the border.

Objectives

Canada Savings Bonds

During this period the development of the Canada Savings Bond instrument and the retirement of deposit certificates held by the banking system were key priorities of the Bank and Finance Department. Earlier, it was noted that the Bank wanted to carry on with the payroll savings campaign as an anti-inflationary device to soak up purchasing power and to encourage thrift.[486] In furthering this goal, the National War Finance Committee commissioned a survey of employers in 1945 to determine the extent of support for a continuation of the programme. The survey found that nearly six of every seven employers favoured such a continuance.[487]

In March 1946, Towers and Henderson met with Bob Bryce and Clark to discuss the form of the proposed savings instrument. At this meeting it was decided to create an instrument to be sold as a "tap issue," that is, throughout the year, in denominations of $50, $100, and $500 *redeemable at banks without a waiting period* to a maximum limit of $2,000 for each purchaser. A single annual coupon of three per cent was contemplated which would be taxable.[488] At the end of June, Towers revealed details of the forthcoming Autumn issue to bankers in Montreal and "expressed the view that a passive approach by the banks would not produce satisfactory results and urged the appointment of something equivalent to Victory Loan officers."[489] In September, Towers sent a letter to bankers to

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[486] W.E. Scott for G.F. Towers to S.M. Wedd, President, Canadian Bankers' Association, 17 July 1945, *The Bank of Nova Scotia Archives*, Secretary's Department Papers 1, File 72, "Ninth Victory Loan".

[487] K.A. Henderson to W.C. Clark, 4 January 1946, *Public Archives of Canada*, RG 19, Volume 593, File 155-30-4.

[488] Towers Memoranda, No. 503, 27 March 1946, "Memorandum of discussions with Clark and Bryce by Henderson and Towers," *Bank of Canada Archives*.

[489] Towers Memoranda, No. 521, 26 June 1946, "Notes re. meeting with General Managers of Banks not including Banque Provinciale, Montreal, June 26th,. 1946," *Bank of Canada Archives*.

counteract "any impression that the operation of this autumn will be in the nature of a very low pressure campaign." While the approach would "differ materially" from the war loans which relied on appeals to patriotism (and conscience), Towers stressed "vigorous salesmanship" and promotion on the basis of "self-interest."[490]

The lukewarm reception of the banks was based on two reasons. Firstly, savings bonds were non-transferable and therefore could not be held by the banks as collateral for loans. Secondly, opposition was based on the traditional perception of bank managers that deposit withdrawals were lost to the banking system.[491] Even within the Bank there was some debate as to the proper development and place of this *non-marketable* debt instrument. On the positive side, the savings bond promised a wider distribution of the debt and it also would minimize the monetization of the debt in the banking system. Some supporters claimed it would lead to greater interest in the area of public finance and to more ethereal advantages such as a public better informed about government finance. Other advantages included limiting the maximum purchases to several thousand dollars which meant the Government could be assured all daily demands for cash could be met quite easily following the traditional banking maxim of maintaining daily reserves sufficient to meet the expected demands for encashment. On the negative side of the ledger, the creation of this borrowing vehicle gave the Dominion ready access to a vast pool of normally, untapped savings. From a central banker's perspective, this could be unhealthy in so far as it might encourage profligacy in government spending when governments realized they could raise great wads of cash by offering a "sweetener" to the population.[492] Another problem area was the cash redemption on demand feature which was potentially inflationary should panic set in among the largely, unsophisticated holders. Related to this question of redemption on demand was the feeling that holders would tend to redeem bonds before the maturity dates and that this run-off and the expense of these campaigns far outweighed the benefits of this savings instrument. Finally, some observers felt that placing too heavy a reliance on non-marketable debt insulated from interest rate

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[490]G.F. Towers to A.W. Rogers, C.B.A. Circular 329-X, 19 September 1946, *The Bank of Nova Scotia Archives*, Secretary's Department Papers 1, File 62, "Dominion of Canada Savings Bonds."

[491]*Interview*, 1 June 1982.

[492]The 1981 savings bond campaign illustrates this. The Government which faced a heavy run-off of the bonds between 1978 and 1981 elected to offer a very high rate of interest. Despite closing the books at the earliest possible date, the Government raised about $13 billion.

movements would make the debt manager less sensitive to price fluctuations in the capital markets.[493]

The Canada Savings Bond was first issued with a 2.75 per cent coupon sold at par from 1946 to 1950, then boosted to 3.25 per cent in 1951 and to 3.75 percent in the Fall of 1952. Sales ranged from a high of $483 million in 1946 to a low of $235 million in 1948. With the secular rise in rates beginning in early 1948, a cashing in of the bonds commenced. By March 31, 1953 of the $1,533 million in savings bonds issued at 2.75 percent only $581,205,500 or 38 per cent remained outstanding. This development demonstrated that the majority of savers were indeed sensitive to market rate trends and cashed bonds in when the rate of interest made the investment unprofitable. In theory, savings bonds were non-marketable debt instruments relatively insensitive to market movements; in practice the cashing of bonds was indeed affected by the trend in bond prices and interest rates. It is quite clear that savings bonds are not cost effective when compared with other marketable debt instruments which are not cashable on demand.[494] The general view seems to be that the distributional benefits exceed the marketing and redemption costs. In summary, the introduction of the savings bond was primarily an attempt to encourage thrift through the payroll savings plan, to institutionalize a system of borrowing to minimize the monetization of the debt, and to encourage a wider placement of the bonds. Table 5.13 indicates that the savings bond campaigns were effective in soaking up Canadians idle savings in the form of this non-marketable instrument. To-day, about one-third of the national debt is held in this form.

Deposit Certificates

Between March 1945 and March 1948, the Government reduced the amount of deposit certificates held by the banks from $1 billion to $100 million.[495] Holdings of longer term, higher yielding government bonds grew to displace the liquidation of these certificates. Many of their securities purchases took place during 1948 as banks purchased bonds of Canadians seeking cash for consumption purposes or for a down payment on a house. Government and Bank policy was aimed at the reduction of these

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[493]Royal Commission on Banking and Finance, *Report*, p. 459. and Robert V. Roosa, 1952, pp. 214-235.
[494] See criticisms made by the Investment Dealers Association on the savings bonds in its submission to the Porter Commission, June 1962, *Proceedings*, Royal Commission on Banking and Finance,, Volume 22A, p. A177B.
[495]*Public Accounts of Canada*, 1945-1948.

short–term, illiquid instruments by running budget surpluses and using savings bonds funds to further reduce bank indebtedness. The reduction of deposit certificates which yielded less than one per cent was vigourously championed by the chartered banks. The evolution of this controversial instrument will be studied in more detail in Chapter VI.

Table 5.12 shows the Government was again effective in meeting its objective of interest rate minimization. Because the period was characterized by the redemption of debt with higher coupon rates, the average cost of the debt continued to fall even after 1948 when rates had begun their slow climb.

TABLE 5.12
Unmatured Debt, Net Debt, Average Rate, 1946-1952

Year	Funded Debt (1)	Average Interest Rate (2)	Net Debt Per Capita$Cdn (3)	Interest per capita $Cdn (4)
1946	18,960	2.63	1091.88	33.24
1947	16,698	2.69	1039.58	36.91
1948	15,597	2.71	964.80	36.29
1949	15,585	2.70	875.74	36.27
1950	15,188	2.68	849.23	32.71
1951	15,027	2.60	816.14	31.01
1952	14,695	2.67	773.59	30.87

SOURCES: *Canada Year Book*, (1946–1953).

TABLE 5.13

Distribution of Debt by Holder, 1946-1952

Year	Central Bank	Govt Acct.	Chartered Banks	NonRes.	Insurance Cos.	Trust Cos.	Non–Marketable Debt (CSBs)
1946	11.00	5.30	19.16	6.30	11.16	1.09	4.18
1947	11.26	5.98	15.85	6.30	11.53	1.17	5.37
1948	12.21	7.63	17.96	7.03	10.76	1.11	5.78
1949	12.70	5.03	19.67	7.84	10.22	1.16	6.69
1950	12.19	5.32	19.32	8.57	9.07	1.16	7.17
1951	14.28	6.58	17.95	7.61	8.60	1.14	7.62
1952	14.68	7.26	18.35	6.29	8.39	1.09	8.20

SOURCES:*Bank of Canada Review*, *Bank of Canada Statistical Summary*, various years.

TABLE 5.14

Interest, Deficit in Relation to G.N.E. Government Expenditure

Year	Interest	Interest %Govt. Expend.	Interest GNE Factor	% Deficit Govt. Expend.	% Deficit/Surplus % GNE Factor
1946	409	8	4.8	−8.2	−2.6
1947	464	18	4.1	+32.3	+6.2
1948	455	21	3.5	+40.2	+5.9
1949	475	22	3.4	+23.3	+3.5
1950	451	18	2.8	+28.4	+4.2
1951	439	15	2.7	+31.3	+5.5
1952	531	14	2.6	+4.5	+1.0

SOURCES:−Column (1) *Public Accounts of Canada* for the year ending March 31, various years. (Columns (1), (5)− millions Canadian dollars)
Columns (2),(3), (4),(5) Cansim Mini Series identifiers: D 30580 (Interest), D30591 (Expenditure), D 40248 (GNE at Factor Cost).

Obstacles

The most formidable obstacles in the way of maintaining stability in the bond markets were (1)moral commitments made during the war to maintain long−term rates at or below three per cent and (2) market developments in New York. Both of these factors conspired towards the end of 1947 to force the Bank to *gradually* lift the lid on interest rates. (Figure 3.3)

During the summer of 1947 a massive run−off of Canada's foreign exchange reserves took place which became the subject of speculation and questions in the House of Commons. Parliamentarians and academics were perplexed by the Bank and Government's position which held that " a drastic increase in interest rates which would be likely to create a situation that might hamper, and even prevent, essential forms of capital investment which Canada needs."[496] The Government was not prepared to see rates rise to combat the capital outflow and raise the costs of financing the war debt nor did the Government contemplate allowing the dollar to float freely (as it eventually did in 1950), so it eventually resorted to borrowing in New York. This exchange crisis coincided with a heavy selling of Victory Bonds which had reached massive proportions in December 1947. The Government, during the Fall, had used its surplus to buy up large quantities and so had the central bank. The question for policy−makers in January 1948 was whether to carry on this stabilization operation or allow market forces to push interest rates upward.

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[496] *Annual Report of the Governor of the Bank of Canada and Statement of Accounts*, 1948, (Ottawa: 11 February 1949), p. 11.

Towers and his colleagues had to navigate between the scylla of the market and the charybdis of past war–time promises.

At a meeting in early January with Clark, Abbott, Towers, Coyne, and Gordon present, the pros and cons of letting interest rates rise were debated. From the Bank's perspective, sensitized by its daily contacts with the market, it was futile, if not impossible, to hold bond prices steady. According to the Governor's recollection of the meeting:

> The present flurry of selling is inspired by the recent upward move of interest rates on U.S. Government securities. However, even after nervous selling subsides, one must expect that the Stabilization Account will be called upon to purchase a very substantial amount of securities during 1948.[497]

In arguing the case for higher rates, the Governor believed that higher rates might bring under control the current capital boom and at the same time re–establish the traditional one–half of one per cent differential between U.S. Federal and Dominion paper. [498] Towers then added

> Finally, as long as Government does not require to borrow in the market, a higher interest rate does not increase the debt costs and permits Government to buy up outstanding issues on more favourable terms. *However, a policy of deliberately varying interest rates to favour the Government's position might ultimately result in higher rates being demanded by investors, or a narrowing of the public bond market.*[499]

Towers concluded his presentation with a plea either for a clear mandate for the current policy of price maintenance or a clear change in policy direction.

Abbott and Clark, while recognizing the current rate structure was unrealistic, preferred to see rates go up marginally (in typical Liberal fashion), by perhaps one quarter of one per cent. Bank officials pointed out that such a movement might be interpreted by the market as only a first step in a movement towards a three per cent par. This reading by the market might necessiate heavier purchases by the stabilization account. Abbott and Clark recognized the possibility and stated that purchases would be financed from surplus funds and borrowed moneys if required.[500] Complicating this difficult choice was the real possibility that war would erupt anew and if the Government did not keep its tacit promises to maintain the value of its bonds, then this would make future war financing far

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[497]Towers Memoranda, No. 561, 5 January 1948, "Meeting with Minister of Finance and Dr. Clark, January 3, 1948," *Bank of Canada Archives.*
[498]*Ibid.*
[499]*Ibid.* (emphasis added)
[500]*Ibid*, p. 3.

more difficult with memories of capital losses still fresh in the minds of potential purchasers.

Soon after the meeting, the Governor advised Clark that steps were being taken "to raise the yield on market issues approximately .22 per cent." To disguise the operation, the Bank abandoned its9previous system of a daily list of bids and offers which was replaced by the bank responding to bids and offers from the market, an institutional adjustment to handle a political problem. No statements were to be issued; according to Towers– "If questioned, the answer would be that there appeared to be some unsettlement in the bond market and some firming of interest rates was apparently taking place. No concern would be expressed."[501]

In early January the administered "break" in bond prices occurred with yields rising some 30 to 35 basis points, slightly higher than was targeted. The success of this policy was premised on a conservative fiscal policy of maintaining high levels of taxation and high budget surpluses. On at least two occasions the Governor informed the Minister that maintenance of the existing fiscal regime was needed to facilitate the control of credit and to keep the confidence of the market. In January 1948 Towers reminded the Minister of "the difficulties in the way of central bank control of credit (and) *emphasized the need for a conservative fiscal policy and maintenance of Government cash surplus at the highest possible figure.*"[502] These recommendations were consistent with maintaining the value for Victory Bonds trading in the secondary market. These sentiments were in evidence again in 1952 when the Governor offered the Minister his thoughts on the forthcoming budget.

> *Looking at the picture from a market rather than a purely economic point of view,* any diminution of the new borrowing requirements is very helpful. The smaller they are, the more likelihood there is that luck or some expedient, or a reduction in exchange reserves, will enable us to get by without a formal borrowing operation from banks or public.[503]

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[501]*Ibid*, p. 4.
[502]Towers Memoranda, No. 564, 29 January 1948, "Notes on discussions with Mr. Abbott, January 29, 1948," (emphasis added), *Bank of Canada Archives*
[503]Towers Memoranda, No. 678, 13 March 1952, "1952–52 (sic) Budget," *Bank of Canada Archives.* (emphasis added) See Towers Memoranda, No. 236, 13 March 1939, "Submission before Rowell–Sirois Commission," p. 6 in which the market's aversion to budget deficits was stressed.

Foreign Exchange Inflows

Another problem which constrained the debt manager occurred during the summer of 1950 when speculation about a possible revaluation of the Canadian dollar mounted. Between June and October an estimated $700 million in U.S. funds poured into Canada. Under the fixed exchange rate regime, U.S. dollars were bought at a fixed rate with U.S. reserves and gold reserves rising accordingly. As the Exchange Fund ran out of Canadian dollars, the Bank of Canada sold securities to the market, almost $350 million worth, to raise cash which had the effect of depressing bond prices and thereby encouraging more capital to flow into Canada. On October second, the dollar was permitted to float upward. In this situation, the objectives of debt management were seriously affected by exchange rate forces emanating from outside the country.

Throughout 1951, efforts were made to maintain bond prices with purchases by the Securities Investment Account. Proposals were mooted at the time involving swaps with the Government's Exchange Fund Account to provide moneys to purchase the Victory Bonds. During the first nine months of 1951, over $273 million in securities were bought but this activity did not stem the rise in rates which inched upward from 3 to 3.25 per cent. By the end of 1951, rates touched 3.5 per cent, nearly one full point above the level at the end of 1947.. In November, the Government officially abandoned its policy of price support.[504]

The reaction of the public to the capital losses from rising bond yields may be gauged from the following quotation of a letter from R.H. Cook to Governor Towers. Cook wrote:

> We are now being told that great pressure is being put on our responsible ministers, which I assume would mean the Minister of Finance, and perhaps also on you as Governor of the Bank of Canada, to raise the rates of interest generally, or in other words take away all support from Canada's War Bonds. If this were done, it would probably be the policy of our life insurance companies, for instance, to keep out of the war bond market until these bonds could again, as following the first war, be purchased down in the low nineties, to net the life insurance companies perhaps 4 to 5 %. The Canadian public want nothing of such manipulation, and there will very soon, in my opinion, be questions asked on the floor of the Commons if the present bonds do not very soon reach par again, and indicate the government's intention to stand by the word of its last responsible Minister of Finance.[505]

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[504]Neufeld, 1958, p. 172n.
[505]R.H. Cook to G.F. Towers, 12 March 1951, *Public Archives of Canada*, RG 19, Volume 589, File 155-1-6.

By 1952, Towers was less sanguine about the Bank's ability to resist market pressures for higher yields.

> One final thought: Lacking an overall cash surplus, any purchase of securities for X account implies (other things being equal) that Government has to borrow money for the purpose. Without suggesting that literally nothing should be done and the market left to its own devices, we should point out to the Minister that buying will be kept to a minimum and the selling pressure, if any, combatted in the main by price reductions.[506]

The regulation of Canada's capital markets had come full circle from a total inability on the part of the state to intervene in setting interest rates to the administered control of rates during the war (with the help of exchange controls) to a post-war return to market forces set outside Canada's borders.

Summary

In summarizing the administrative history of debt management, it should be emphasized that the establishment of the Bank of Canada's provided the impetus for a broader, more impersonal, market in Dominion bonds. Its creation marked the transcendence of an era in which loans were negotiated behind closed doors between the chartered banks and the Dominion. The most notable innovations fostered by the Bank and the policy-makers at Finance included the fortnightly auction of treasury bills, the deposit certificate, and the Canada Savings Bond. The presence of the Bank brought, or was seen to bring, a stabilizing effect on Canada's capital market. The central bank could afford to take a longer term perspective and to accept losses on sales from its portfolio in order to prevent what it perceived to be unwarranted speculation in the market for Canada bonds. Throughout this review it should be apparent that the Bank "listened to the market" more so than did officials in the Department of Finance who were policy-makers and did not actively confront the market's reactions to certain policies pursued by the government.

There can be little doubt that *interest rate minimization* was the central goal of the debt manager during the whole period. All efforts at conversion and funding were taken with a view to minimization of interest charges. This orientation was very clear during the war when capital markets were tightly controlled and the market power of the Bank of Canada, with its huge holdings of government debt orchestrated a decline in both

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[506] *Ibid.*

long and short–term rates.

With regard to the other goals of spreading the maturity structure and retaining flexibility, there is very little evidence to suggest that a *balanced maturity structure* was fervently pursued. To be sure, when a loan was issued there was consideration given as to whether the proposed maturity date would produce a bunching up of maturities, although this procedure appeared to be more of an administrative formality. Primary consideration in this matter was tailoring the maturity date to meet the needs of the market through an informal sounding of the portfolio requirements of the major institutional investors to ensure the bonds were absorbed with a minimum amount of disturbance. *Flexibility* in debt management operations was improved during the period by the government changing the character of the instruments traded in the secondary market. With the Conversion Loan of 1931, the government established a policy of introducing the call feature. As well, during the 1930s the Dominion moved to retire the outstanding issues of optional payment bonds which exposed the debtor to rather severe exchange rate risks. The introduction of the treasury bill and the deposit certificate tailored specifically for the banking system were further examples of developments which were aimed at reducing the cost of borrowing.

The foremost obstacle faced was the *form* of the debt. Optional–pay bonds, call features, tax–exempt bonds, non–callable bonds and extendibles are features which reduce the flexibility of the debt manager. To–day extendibles and the cash redemption feature of savings bonds are prime examples of debt forms which have quite undesirable underlying characteristics. Extendibles, introduced as a sweetener, allow the holder to extend the term of the bond. So, if interest rates fall the holder will elect to extend the term. The borrower then cannot re–finance at the lower rates, then current. Canada Savings Bonds may be regarded as a time bomb in the sense that they can be cashed in at any time. Should panic take hold of the holders, a run on Canada Savings Bonds would have disastrous inflationary effects.

Market instability proved to be most salient when foreign exchange controls were absent. This brief history reveals the skittishness of the capital markets to rumours of default, repudiation, change of government, and changes in rates of interest and rates of exchange. The phemonena of "unsettled markets" made the timing and judgement

crucial in planning when to refund or sell a new issue for at certain times "breaks" in the market were more likely to occur than at other times. Typically the tone of the market was determined in New York and London during the 1930s. After the War the Dominion's foreign debt, though small, was situated in New York and the Canadian market took its signals from U.S. capital markets.

The final structural obstacle which confounded debt managers during the 1930s was the formidable position of the banks' combined market clout when refunding was contemplated. Negotiations on rates were characterized by regular, formal meetings in the Fall between the debtor and the major creditors. This non-market, personalized form of financial transaction was superseded as the Bank of Canada became the Government's intermediary. Eventually, discussions between the central bank and chartered banks moved into the general realm of credit and interest rate policies. While the war experience offered an exception to this (the issue of the deposit certificates), the Bank was successful in weaning the banks from their former behaviour of negotiating rates and terms for Dominion loans.

On the political front, the greatest obstacle created was the moral commitment made during the War to holders of Victory Bonds. This commitment, taken to its logical conclusion, effectively pledged the debt manager to selling longer term bonds at three per cent or less *indefinitely*.[507] A final constraint which may be termed political is the attentiveness paid by debt managers to capital markets which has been alluded to several times. It is the market which decides whether an issue will be a success or not. In respecting and "listening to the market", debt managers accept the fundamental assumption that it is the *market* which is the most efficient form of distributing wealth.[508] This is a *political* assumption which holds that governments should not tinker with the market even if it would be in their best interest to do so. *In short, there was a fundamental agreement amongst the players that the market is the final arbiter and this acceptance then accords to the market system legitimacy* in the distribution of income yielding securities. The acceptance of this world view by key government officials is crucial for it brings into doubt any government scheme which aims at the reallocation of wealth, an activity which is

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[507] *Interview*, 1 June 1982.
[508] *Interview*, Ottawa, 9 June 1982. This view seemed to be more sacred with personnel at the Bank than with the more academic, policy-making officials at Finance.

completely foreign to a market system with perfectly mobile capital.

TABLE 5.15

Distribution of Debt by Term to Maturity, 1938-1952

Year	T-bills (%)* (1)	Bonds under 3 yrs(%)* (2)	3-5 yr(%) (3)	5-10 yrs(%) (4)	10 yrs+(%) (5)	Avg Term to Maturity Months (6)
1938	6.6	7.6	13.5	11.8	60.5	153
1939	10.8	9.5	16.1	10.1	53.4	140
1940	15.7	9.5	12.8	9.4	52.6	125
1941	18.6	8.6	12.1	20.5	40.1	110
1942	21.1	7.0	7.5	24.8	39.7	101
1943	20.2	2.8	12.2	14.8	49.9	105
1944	17.9	4.7	10.0	15.4	51.9	110
1945	10.7	6.2	10.0	13.2	59.9	126
1946	9.7	8.4	11.9	14.3	55.8	119
1947	7.9	8.6	12.9	19.5	51.6	115
1948	8.7	9.8	10.8	20.5	50.3	106
1949	8.3	16.7	7.4	24.8	42.9	100
1950	10.3	8.6	10.3	34.2	36.6	97
1951	10.0	8.4	17.7	26.5	37.5	90
1952	10.1	15.1	18.4	28.1	28.3	81

SOURCES:—Bank of Canada, *Bank of Canada Review*, *Bank of Canada Statistical Summary*, various years.
*—under two years, 1938–1959.

Table 5.16

Synopsis of Major Domestic Borrowing, 1930–1952

Date of Issue	Amount $Cdn.	Coupon Rate (%)	Purpose
December 1, 1930	40,000,000	4.00	Refunding
May 1931 *	638,609,300	4.50	Conversion
November 1931	221,198,200	5.00	Refunding/Cash
August 1, 1932	50,000,000	4.5	Cash
October 15, 1932	81,191,000	4.00	Refunding/Cash
November 1, 1932	35,000,000	4.00	Cash
May 31, 1933	40,000,000	3.50	Cash
October 15, 1933	225,000,000	3.5 & 4.0	Cash/Conversion
October 15, 1934	63,336,000	2.00	Cash/Conversion
October 15, 1934	7,933,000	2.50	Cash/Conversion
October 15, 1934	40,409,000	3.00	Cash/Conversion
October 15, 1934	138,322,000	3.50	Cash/Conversion
September 15, 1935	135,000,000	1.5 & 2.0	Refunding
June 1, 1936	134,703,000	1.5&3.25	Conversion
September 15, 1936	45,000,000	1.00	Cash
September 15, 1936**	55,000,000	3.00	Cash
June 1, 1937	60,000,000	2.00	Conversion
June 1, 1937	20,000,000	1.00	Conversion
June 1, 1937	33,500,000	3.25	Conversion
June 1, 1938	90,625,000	2.00	Cash/Conversion
June 1, 1938	49,225,000	3.00	Cash/Conversion
May 15, 1939	95,500,000	1.50	Cash/Conversion
May 15, 1939	39,000,000	3.00	Cash/Conversion
October 16, 1939	200,000,000	2.00	Cash/Repatriation
February 1, 1940	250,000,000	3.25	First War Loan
May 1, 1940	250,000,000	1.00	Gold sale to FECB
January 2, 1941	250,000,000	1.50	Chartered banks
June 15, 1941	193, 286,000	2.00	War/Conversion
June 15, 1941	643,534,250	3.00	War/Conversion
March 1, 1942	57,169,000	1.50	War
March 1, 1942	269,879,000	2.25	War
March 1, 1942	669,658,000	3.00	War
November 1, 1942	144,253,000	1.75	War
November 1, 1942	847,136,050	3.00	War
May 1, 1943	197,455,000	1.75	War
May 1, 1943	1,111,261,650	3.00	War
July 2, 1943	200,000,000	1.50	Chartered banks
November 1, 1943	373,259,000	1.75	War
November 1, 1943	1,197,324,750	3.00	War
May 1, 1944	239,713,000	1.75	War
May 1, 1944	1,165,300,350	3.00	War
November 1, 1944	344,267,000	3.00	War
November 1, 1944	1,365,639,200	3.00	War
May 1, 1945	267,800,000	1.75	War
May 1, 1945	1,295,819,350	3.00	War
November 1, 1945	335,690,000	1.75	War
November 1, 1945	1,691,796,700	3.00	War

Table 5.16 (contd)

Date of Issue	Amount $Cdn.	Coupon Rate	Purpose
November 1, 1946	400,000,000	1.75	Refunding
CSB 1946-47	483,410,000	2.75	Cash
May 1, 1947	200,000,000	0.62	Cash
CSB 1947-48	263,530,150	2.75	Cash
March 1, 1948	145,000,000	1.50	Cash
CSB 1948-49	235,258,360	2.75	Cash
CSB 1949-50	288,904,400	2.75	Cash
August 30, 1950	300,000,000	.875	Cash/Conversion
June 15, 1950	395,000,000	2.00	Refunding
June 15, 1950	350,000,000	2.75	Refunding
November 1, 1950	300,000,000	1.75	Refunding
November 1, 1950	400,000,000	2.25	Refunding
CSB 1950-51	261,993,600	2.75	Cash
CSB 1951-52	357,649,750	2.0 & 3.5	Cash
July 23, 1952	100,000,000	1.50	Cash/D.C.s
CSB 1952-53	340,304,350	3.75	Cash

SOURCE: *Public Accounts of Canada*, (Ottawa: various years).
CSB sales figures as at March 31 of year succeeding initiation of campaign.
*– See Table 5.3.
**– Perpetual issue.

VI. THE CHARTERED BANKS

This chapter investigates the relations between the debtor Dominion Government and a major institutional creditor, the chartered banks. In reviewing the dealings between banks and government, it is hypothesized that the imperatives of the banks balance sheets, collectively and individually will determine the character of negotiations which took place during the period. In the first section, the nature of commercial banking in the Canadian context will be described and the structure of the industry. The succeeding sections will consider, *inter alia*, negotiations prior to and immediately after the formation of a central bank, the question of Alberta's new Social Credit government and its effect upon the federal structure of Canadian banking, the deposit certificate controversy, and lastly the changing influence of the Government over the commercial lending practices of the chartered banks.

Nature of Commercial Banking

> A particular banker lends among his customers his own promissory notes, to the extent, we shall suppose, of a hundred thousand pounds. As those notes serve all the purposes of money, his debtors pay him the same interest as if he had lent them so much money. This interest is the source of his gain. Though some of these notes are continually coming back upon him for payment, part of them continue to circulate for months and years together. Though he has generally in circulation, therefore, notes to the extent of several hundred thousand pounds, twenty thousand pounds in gold and silver may, frequently, be a sufficient provision for answering occasional demands. By this operation, therefore, twenty thousand pounds in gold and silver perform all the functions which a hundred thousand could otherwise have performed.
>
> Adam Smith[509]

As all chartered banks are federally regulated deposit-accepting institutions, that is financial institutions which accept savings from the general public for deposit, they are closely regulated under the federal *Bank Act* which is revised, according to statute, every ten years. The Act provides the legislative framework for a *branch* as opposed to a *unit* banking system as in the United States. A branch banking system is seen as superior to a unit banking system due to its capacity to draw upon a wide base of deposits. A wide deposit base provides essential stability to a banking system by reducing the fear that one or two major deposit withdrawals, for instance a major corporate client, could precipitate

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[509] *An Inquiry into the Nature and Causes of the Wealth of Nations*, Andrew Skinner (ed.), (Harmondsworth: 1970), p.389.

a calling of loans and a run of the bank by depositors wishing to redeem their notes. This type of fear was particularly acute in the last century when banks were much smaller and regionally concentrated and bank notes were redeemable in specie making a bank especially vulnerable to periodic depressions and the loss of faith of depositors and noteholders. Currently, it is argued, cyclical downturns in the auto or pulp and paper industry can be offset by gains in the clothing or agricultural sectors thus obviating the problems of a narrow depositor and loan base. During the Great Depression, criticism of Canadian banks was somewhat muted because no bank failed in contrast with the U.S. which saw thousands of bank insolvencies and this was attributed to the advantages and inherent soundness of the Canadian branch banking system.[510] Offsetting the benefits of a branch banking system was, and is, the general lack of competition in Canadian banking, which the bankers themselves tacitly admitted. In testimony before the Royal Commission on Banking and Currency, C.B.A. witness Morris Wilson stated

> In practice, however, it would usually be found that the policy of one bank is the policy of all banks.........Moreover, it is improbable that a restrictive policy would be made effective until the views of the other General Managers in this respect to the business situation had been obtained. Even if these views were at variance, the restrictive policy might still be adopted, but such divergance would hardly be of long duration; were all concerned placed on notice to watch the situation particularly carefully, one view or the other would shortly be felt by all to be correct.[511]

In Canada, with fewer than one dozen banks this sort of informal consultation to ensure that the "correct view" was taken could be more easily accomplished than in the United States with literally tens of thousands of regional banks.

The business of banking involves the accepting of deposits, on which interest is paid (liabilities and expenses), shareholders' capital (equity) and the lending of deposits and equity to borrowers at a mark-up. As loans in the form of an overdraft privilege represent deposits which are held within the entire banking system it was possible to expand loans normally up to ten times the bank holdings of specie and cash reserves. This credit creation was what Social Crediters popularized as bankers' "fountain pen money." The "spread" between banks' deposit rates or expenses and their investment earnings from security holdings and loans constitutes the main source of bank profits. Profits on

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[510] *Interview*, 3 June 1983.
[511] *Proceedings*, Royal Commission on Banking and Currency, Ottawa, 14 September 1933, p. 3154.

foreign exchange transactions were also a source of earnings and of losses.

In a certain sense, the function of banking may be regarded as a social function, that is of mobilizing idle money balances and transferring the funds to individuals and corporations requiring these moneys. According to the Marxist economist, Ernest Mandel:

> Contrary to the industrialist and trader, the banker has in fact to play a social role *directly*. He is useful to the capitalist mode of production only to the extent that he can overcome the fragmentation of social capital into the multitude of individual properties. It is in this function of *mobiliser* and *centraliser of social capital* that his whole importance to society consists. This function goes beyond the class limits of the bourgeoisie in the strict sense and embraces the centralisation of funds saved by landowners, rich and middle peasants, craftsmen, civil servants, technicians, and even skilled workers in prosperous periods.[512]

The *Bank Act* goes into minute detail specifying the type of security/collateral which the banks may acquire when lending and their powers as secured creditors. Unlike life insurance and trust companies, banks primarily lend for a short term, that is less than two years. Banks therefore held short-term government paper which could be liquidated to provide funds to "write" new loans.[513] Historically Canadian banks issued their own bank-notes whose circulation was limited to the shareholders' paid-in capital and bank reserves. Prior to the establishment of a central bank, chartered banks paid a one per cent tax per year on their outstanding note issue. Notes of a bank were, until August 1914, payable in specie. Limitations on the note issue were lifted after the panic of 1907 which permitted an expansion by 15 percent of a bank's issue beyond capital and reserves for the crop moving season between September 1 and February 28. A tax of five per cent was payable to the Minister for excess circulation.[514] Table 6.1 indicates that the total bank notes outstanding during 1928 and 1929 were about $30 million more than permitted under the Act. After the market crash in October 1929, the note circulation contracted abruptly falling by 1933 to well below the amount authorized by statute. This curtailment in turn led to an equally precipitous fall in commercial loans. After 1935, the chartered banks gradually retired their note issue so by 1952 only a handful of private bank-notes were in circulation.(Table 6.1) After 1935, Section 27 of the Bank of Canada Act required banks to place on deposit with the Bank of Canada a sum equal to five per cent of their

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[512]Mandel, p. 221.
[513]*Interview*, 14 June 1982.
[514]Testimony of J.A. McLeod, President, Canadian Bankers' Association, *Proceedings*, Royal Commission on Banking and Currency, Ottawa, 8 August 1933, p. 69.

liabilities in the form of Dominion notes or deposits. These deposits earned no interest and dicennially the annoyance of chartered bankers is expressed who feel this stipulation is unjust (trust companies which took deposits from the public and loaned money were exempt from holding non-interest bearing reserves at the central bank). Variation of these "reserve requirements" allows the central bank to ease credit conditions (lower requirement) or restrict credit (raise the level).

Until the 1967 Bank Act revision, banks were unable to lend upon the security of property and real estate i.e. mortgages, a provision which followed the Hamiltonian, Bank of the United States model. Banks were also restricted in the distribution of securities to the public; their role being limited to Dominion issues and handling sales in remote areas. Table 6.1 shows the liabilities of the banks for the period 1928 to 1952. Paid-in Capital grew rapidly between 1928 and 1930, the boom years, and thereafter remained static until the early 1950s. Similarly, reserves which represent the amount of bank profits retained in the business grew until 1931 and declined as decreases in bank profitability prompted their reduction to meet dividend pay-outs in 1932 and 1933 . Capital and reserves represent the claim of shareholders in the event of winding up *after* the noteholders and depositors claims were satisfied. commercial lending (Table 6.2).

TABLE 6.1

Composition of Chartered Bank Liabilities 1928-52

Year	Capital	Capital Reserve	Bank-notes	Demand Deposits	Notice Deposits	Total Liabilities
1928	122.8	134.1	176.7	677.5	1,496.6	3,044.7
1929	137.3	150.6	178.3	696.4	1,479.9	3,215.5
1930	144.6	160.6	159.3	622.9	1,427.6	2,909.5
1931	144.7	162.0	142.0	578.6	1438.0	2,741.6
1932	144.5	157.3	132.2	486.3	1,376.3	2,546.1
1933	144.5	132.6	130.4	488.5	1,378.5	2,517.9
1934	144.9	132.8	135.5	514.0	1,372.8	2,548.7
1935	145.5	133.0	125.6	568.6	1,445.3	2,668.0
1936	145.5	133.0	119.5	618.3	1518.3	2,855.6
1937	145.5	133.8	110.3	691.3	1,573.7	3025.7
1938	145.5	133.8	99.9	690.5	1,630.5	3,056.7
1939	145.5	133.8	94.1	741.7	1,699.2	3,298.4
1940	145.5	133.8	91.1	875.1	1,646.9	3411.1
1941	145.5	133.9	81.6	1,088.2	1,644.8	3.711.9
1942	145.5	135.1	71.7	1,341.5	1,864.2	4,102.4
1943	145.5	136.8	50.2	1,619.4	1,864.2	4,849.2
1944	145.5	136.8	37.1	1,863.8	2,272.6	5,689.4
1945	145.5	136.8	28.6	1,986.1	2,750.4	6,438.6
1946	145.5	144.7	23.2	2,155.3	3,327.1	7,124.0
1947	145.5	178.0	19.7	2,138.8	3,681.2	7,476.6
1948	145.5	182.4	17.1	2,258.7	3.972.2	7,798.9
1949	1,45.5	187.0	14.7	2,353.0	4,333.9	8,310.2
1950	145.5	200.0	.4	2,562.8	4,547.9	8,660.2
1951	146.5	200.8	.3	2,711.5	4,592.9	9,019.8
1952	148.5	211.8	.2	2,931.6	4,811.5	9,384.1

(in $millions Canadian)

SOURCES: *Canada Year Book*, 1946, p. 963 ; 1954, p. 1135.

The largest liability of a chartered bank was the "notice deposit". Thousands of savings deposits earning from two to three percent (1.5 per cent during the war) provided banks with approximately fifty percent of their funds while demand or chequable deposits (mostly for businesses) represented almost thirty percent of a bank's liabilities. Notice deposits required a thirty day notice that funds would be withdrawn although this condition was usually waived for small depositors. Demand deposits were essentially drafts against a bank account payable to a third party through the banks' cheque clearing system. Table 6.1 illustrates the close correlation between declines and rises in demand deposits with the note circulation. Demand deposits were near cash and mainly represented the accounts of larger corporate clients. These firms would not put surplus cash in a bank account at low

rates but would employ these funds in the equity and debt capital markets in Canada and abroad. The level of demand deposits was very sensitive to business conditions and the level of available credit. Notice deposits, on the other hand, remained relatively stable during the Depression. While demand deposits dropped thirty percent and note circulation twenty-seven percent between 1929 and 1933, notice deposits fell by a more modest seven per cent.

Assets

During the period under study, a bank's investment strategy was based upon "asset management". Because changes in a bank's liabilities (deposit base) were relatively minor, the head office was primarily concerned with liquidity and yield and not "matching" the term to maturity of deposit liabilities against the maturity schedules of bank investments. Today, in contrast, banks must have a fairly close maturity match between their assets and their liabilities. For example, in order to write up a five year loan, bankers' attempt to raise deposits with a similar maturity.

In the 1930s, Dominion bank notes, essentially a claim on the Government's gold reserves prior to 1931, and specie paid in by the original shareholders were offsets against the demands of noteholders and depositors. The decline in specie and Dominion bank note holdings paralleled the decline in bank-notes from 1929 to 1933. The decline in specie was partially due to the practice of the banks exporting gold, by utilizing the open-ended terms of the *Finance Act*,to New York's call loan market.[515]

As Table 6.2 indicates, after 1929 a sudden contraction of commercial lending took place. This shift was caused primarily by the serious loss of faith resulting from the deflation experienced in 1930-1931. Banks shifted their investment portfolios from the more lucrative commercial lending, which carried greater risk of losses, to gilt-edged government securities carrying virtually no risk of default. During the 1930s, this tendency to become more risk averse quadrupled bank holdings of government paper while commercial loans were cut nearly in half. This development gave rise to the often heard charge that banks were not fulfilling their obligations to agriculture and industry.[516]

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[515]This process was retarded somewhat when in 1928, the Government effectively abandoned the gold standard. See C.A. Curtis, "The Canadian Monetary Situation." *Journal of Political Economy*, Volume 40, No. 3 (June 1932), pp. 314-337.

[516]For example, *The Western Producer*, "The Banks," 20 April 1933, p. 6. "By running to cover immediately economic disturbances arise, by leaving industry and agriculture to fend for themselves, by withdrawing itself as rapidly and as completely as possible inside of its

According to one student of Canadian banking though, the increase in securities holdings was "well advanced" before the Great Crash– the crash simply accelerated this trend.[517] Furthermore, as the banks often claimed, they had too much cash in their tills with too few credit–worthy customers who would borrow. While there little doubt that the economics of banking gave banks an incentive to lend to industry and commerce there remained a widespread fear, bordering on incapacitation, that loan losses would easily erase earnings from good loans which led to a systemic contraction of credit.[518]

TABLE 6.2
Composition of Chartered Bank Assets 1928-52

Year	Specie and Bank Notes	Dom. & Prov. Securities	Total Loans	Total Assets	Loans/Securities
1928	264.8	333.8	2,072.4	3,323.2	6.2
1929	261.6	341.7	2,279.2	3,528.5	6.7
1930	232.0	316.2	2,064.6	3,237.1	6.5
1931	208.0	454.4	1,764.1	3,066.0	3.9
1932	206.9	489.7	1,582.7	2,869.4	3.2
1933	209.6	626.9	1,409.1	2,831.4	2.4
1934	214.4	683.5	1,373.7	2,837.9	2.0
1935	227.7	860.9	1,276.4	2,956.6	1.5
1936	240.6	1,074.8	1,140.6	3,144.5	1.1
1937	249.4	1,118.9	1,200.6	3,317.1	1.1
1938	262.4	1,143.0	1,200.7	3,348.7	1.1
1939	280.0	1,234.1	1,243.6	3,348.7	1.0
1940	296.9	1,311.6	1,324.0	3,707.3	1.0
1941	318.0	1,483.3	1,403.2	4,008.4	.95
1942	349.7	1,806.9	1,370.4	4,399.8	.76
1943	422.6	2,404.8	1,334.1	5,148.5	.55
1944	538.2	2,998.0	1,343.9	5,990.4	.45
1945	604.8	3,438.8	1,505.0	6,743.2	.44
1946	686.4	3,734.9	1,642.5	7,429.6	.44
1947	679.1	3,395.3	2,125.6	7,810.9	.63
1948	719.5	3,314.3	2,338.6	8,140.1	.72
1949	762.9	3,573.3	2,618.4	8,657.8	.73
1950	770.0	3,563.0	2,872.4	9,015.1	.81
1951	799.3	3,134.2	3,495.7	9,384.8	1.1
1952	851.0	3,271.1	3,607.9	9,760.5	1.1

(in $millions Canadian)
SOURCES: *Canada Year Book*, 1946, pp. 963–964; 1954, p.1135.
(Assets include foreign assets which explains discrepancy between Tables 6.1 and 6.2)

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[516](cont'd)own comparatively safe retreat– by these means a banking system can come through very difficult times relatively unscathed and owing to the relative immunity from injury, strengthened."
[517]J. Douglas Gibson, "The Changing Character of Bank Assets," *The Journal of the Canadian Bankers' Association*, Volume 45, No.2, (January 1938), p.149.
[518]See F.C. Biggar, "Monetary Misconceptions," Speech before the Rotary Club of Montreal, Tuesday, June 23rd, 1936, p.6.

This conservatism or prudence did not have a detrimental effect on the spread between interest expenses paid depositors and interest earnings. Since banks could not earn above the legal maximum of seven percent, they practised "discounting" referred to in Chapter IV which yielded seven to ten percent and aroused accusations of usury from the farming community. The spread on these risky loans which might be as high as five percent narrowed to about 150 to 200 basis points on government bonds. Nevertheless, the servicing costs on $10 million in government bonds was neglible when compared with the administration of $10 million in farm loans. During the Depression the banks had truly turned "from the financing of industry and trade to the financing of relief payments, assistance to the 'unsheltered areas' and railways deficits"– indeed, a social function.[519]

During the war, the banks' securities holdings trebled as the Dominion's debt came to totally dominate the Canadian capital market. Commercial lending which saw a small increase early in the war was effectively frozen as the Dominion, through the deposit certificate mechanism, monopolized the supply of credit made available through increases in deposits. From 1946 to 1952 loans more than doubled prompting utterances from the central bank that *capital projects* should be financed without short-term bank credits.[520] In spite of this expansion of credit, it was not until 1952 that commercial lending replaced security holdings as the largest asset of the chartered banks.

In the post-war period an agreement was entered into between the banks and the Government to limit the banks' security holdings to a maximum of 90 per cent of notice deposit liabilities. This was supposedly done to avoid criticism that the banks were living off government bonds.[521] From the Government's perspective this agreement did not seriously hamper its flexibility since the plan was to retire rather than increase the Government's outstanding liabilities. This agreement effective in March 1946 was aimed at discouraging the banks from purchasing the higher yielding, long-term Victory Bonds from the general public which did occur in 1948-49. These purchases had a negative impact on bank earnings in 1950 and 1951 when a reduction of their security portfolios coincided with a fall in long-term bond prices when credit demands were high. The following quotation from the Association's submission to the Porter Commission

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[519] Gibson, 1938, p. 151.
[520] *Annual Report of the Governor of the Bank of Canada and Statement of Accounts*, 1948, (Ottawa: 11 February 1949), p. 79.
[521] Neufeld, 1958, p. 184.

highlights the problems facing banks when increased government borrowing meets rising credit requirements.

> If the federal government employs the counter-cyclical device of deficit financing, it may call upon the banks, directly or indirectly, to take up sizeable new issues of securities. The central bank may enable this to be done by providing the banks with sufficient reserves to support large scale buying. Easy monetary conditions imply relatively low rates of interest so that the banks have often found themselves buying bonds at high prices (low yields), knowing that later on they might have to sell at low prices (high yields)– in order to accommodate their customers when conditions changed and money became tight. The only way out of this dilemma has been to hold a substantial volume of securities which mature within a short time. Of course this means sacrificing yield for liquidity.[522]

This dilemma reveals the tension between the interest minimization goals of debt management and evolving counter-cyclical fiscal policies undertaken by government and the objectives of commercial lending by chartered banks.

Liquidity

A very important aspect of banking deals with the liquidity of bank assets. Liquidity refers to the near-liquid nature of an asset (loan, security) or the assets' proximity to cash. Closely associated with liquidity is marketability–can an asset be readily sold to meet, for instance, depositors' cash demands? Or, alternatively, how easily can a security be liquidated in order to write up a new commercial loan? This need for liquidity prior to 1935 was satisfied, in large measure, in New York's call loan market. These "call loans" could be called by the bank one day and were settled on the next banking day. After the Bank of Canada was established, it became for all intents and purposes, the sole jobber of Canada bonds and bills by quoting firm prices for standard lots (normally $25,000) of all outstanding issues. Bills could be sold to the bank for settlement in Bank of Canada funds the very same day.[523] This enabled the banks to acquire ready cash resources in much the same fashion as in New York without the export of funds. In 1942, the introduction of the deposit certificate angered bankers because the bank was not prepared to repurchase these instruments except to adjust relative holdings amongst the banks. This debate, which will be explored later, reflects the sensitivity of banks to carrying *non-marketable*, illiquid obligations with a rather indefinite term to maturity.

Industry Structure

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[522]Canadian Bankers' Association, "Bank Investments," in Cairns and Binhammer, (eds.), 1965, p. 271.
[523]Ralph B. McKibbin to author, 27 April 1982.

The Canadian Bankers' Association was formed in 1890 as a mechanism for coordinating the banks' dicennial lobbying in respect to the *Bank Act* and as a formal mechanism for monitoring the health of the industry. In 1900, the Canadian Bankers' Association was formally recognized in *An Act to incorporate the Canadian Bankers' Association*.[524] In the 1901 revisions to the Act, the Association was given authority to supervise the issue and destruction of bank-notes and certain powers of inspection and supervision. In the event of insolvency, it was empowered to act as "curator" and, if possible, to arrange the sale of the assets to another bank.[525] The creation of the Canadian Bankers' Association and the 1901 amendments sanctioned for the first time an institutional framework to resolve the recurring problems of bank insolvencies by making the industry itsel responsible for seeking out ways to prevent losses to noteholders and shareholders. The amendments led to a wave of takeovers and mergers in the banking industry during the first two decades of the twentieth century.[526] In the decade preceding the revision, there were no bank mergers or takeovers with five bank failures; between 1900 and 1910 ten banks merged while three failed. [527] Leading the list of acquisitors was the Bank of Montreal which absorbed the Exchange Bank of Yarmouth, the People's Bank of Halifax and the People's Bank of New Brunswick.[528] This merger movement made it in turn more difficult for regional banks to get off the ground. Of the 11 charters issued and banks opening for business between 1900 and 1920, three banks failed while the remainder were absorbed by larger institutions, several of which were ultimately taken over.[529] All the banks operating in 1930 had received their charters before 1900.

The concentration of the industry is revealed by the fact that by 1930, the two leading banks, the Royal Bank and the Montreal, both headquartered in Montreal controlled nearly $2 billion in assets, roughly 55 percent of all assets! The Big Four which included The Canadian Bank of Commerce and The Bank of Nova Scotia, controlled $2.9 billion in assets, that is nearly 85 per cent of total assets. The remaining six banks controlled a

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[524]62-63 Victoria, Statutues of Canada, 1900, Chapter 93.
[525]*The Bank Act*, Revised Statutes of Canada, 1906, Chapter 29, Sections 117-123 (curator functions), 99-111 (purchase of bank assets).
[526]See C.G. Coote's memorandum in *Proceedings*, Royal Commission on Banking and Currency,Volume 7, pp.48-49.
[527] See S. Sarpkaya, "Counting Canada's Banks," Reprint from *The Journal of the Canadian Bankers' Association and ICB Review*, October and December 1978.
[528]See Merrill Dennison, *Canada's First Bank*, Volume II, (Toronto: 1967), pp. 278-280.
[529]See B.H. Beckhart, "Fewer and Larger Banks," in E.P. Neufeld, (ed.), 1964, pp. 196-205.

share which was much smaller than that controlled by each of the two majors (Montreal, Royal). The concentrated nature of the industry also shows up in the distribution of head offices. Montreal was the headquarters of the two largest banks, two smaller French Canadian banks, and Barclays Bank while Toronto was home to the other banks. Neither the Maritimes,[530] or the West were home to any indigeneous, financial institutions which could compete with the Montreal and Toronto–based banks.

Towards a Central Bank

Relations between the Government and chartered banks were decidedly cool throughout the Bennett interlude. The background to the deterioration involved the public's displeasure with the banking system's performance. The main source of criticism came from Western farmers who complained when harvests were bountiful and wheat prices rising, credit was readily available, but the moment prices dropped, banks were unwilling to provide credit or extend the loans. In Parliament, U.F.A. and Progressive members from Alberta notably William Irvine and G.G. Coote and Saskatchewan M.P.s W.J. Loucks and H.E. Spencer were prominent in their unrelenting attacks against the "money power". Spencer and Coote pushed for the creation of a central bank to "reflate" the money supply. As Table 6.2 shows, bank loans peaked in 1929 and rapidly declined to one half their worth by 1936. The effects of this drying up of credit on agriculture and industry were devastating. As earlier noted the purchase by banks of large amounts of government paper gave rise to the accusation that banks were not chartered to act as gigantic depositories for government securities.[531]

In contributing to the debate on monetary problems, *The Financial Post* released a pamphlet "Is it desirable to establish a central bank in Canada?"– a collection of articles by bank officers opposing a central bank on the grounds that (1) it would lead to inflation, (2) it was unnecessary and a waste of the taxpayers' money, (3) it was unlikely to spell recovery as many supposed, and (4) the absence of a viable money market made the project untenable. The issue of a central bank became the focal point on which the

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[530]The Nova Scotia's executives were all located in Toronto. Annual meetings were held in Halifax.

[531]See for instance "Banking, Currency, and Jackson Dodds," *The Western Producer*, 13 April 1933, p. 6 and "Bankers and Government," *The Western Producer*, 28 September 1933.

monetary reformers pressed the government for a redefinition of the roles and responsibilities within Canada's financial system. With the exception of the Royal Bank, the remaining nine banks opposed the scheme.[532] Not surprisingly, the Bank of Montreal which as the Dominion's fiscal agent had the most to lose from the proposal, spearheaded opposition to the move.[533]

Initially Bennett was not that receptive to establishing a new government corporation. When meeting with the General Managers in Ottawa in October 1932, the Prime Minister indicated that he had circulated a memorandum prepared by J.A. McLeod to his colleagues and referred to the suggestion that a committee of financial and banking experts "be appointed to control, as it was understood, the volume of credit to be granted under the Finance Act."[534] However the failure of the banks to extend credit, coupled with the appointment, in October 1932, of W. Clifford Clark as Deputy Finance Minister, set the stage for a central bank.[535] The extent of Bennett's annoyance towards the banks may be gauged from the following exerpt of a letter to C.B.A. President J.A. McLeod in June 1933. In the letter, Bennett denounced the banks "for driving customers to the wall who are unable to liquidate their liabilities under existing economic conditions." Bennett also reminded the C.B.A. President that he would be overseeing the upcoming Bank Act revisions. [536] On July 31, 1933 Bennett announced the appointment of a Royal Commission on Banking and Currency to be chaired by the Scottish jurist Lord Macmillan who, several years earlier, had undertaken similar duties in Great Britain.[537]

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[532]Interestingly enough, the earliest proposal for a government bank was authored by Lord Sydenham. See H.T. Davoud, "Lord Sydenham's Proposal for a Provincial Bank of Issue," *The Journal of the Canadian Bankers' Association*, Volume 45, No. 3 (April 1938), pp. 289–298. The Royal Bank, possibly because it did not have the lucrative relationship which the Montreal enjoyed *vis-a-vis* the Dominion, was an early advocate of a central bank. After World War I, a committee of the Canadian Bankers' Association was struck to examine the question for the Minister of Finance, Thomas White. E.L. Pease of the Royal Bank turned out to be the only supporter of the idea. See Grayson, 1974, Chapter II.
[533]See remarks of Sir Charles Gordon, President, Bank of Montreal, *Annual Report, 1933*, p. 8.
[534] C.B.A. Circular 95–U, "Minutes of Meeting of with the Prime Minister and Minister of Finance with the Members of the Association held in the Office of the Minister of Finance in Ottawa, Monday, October 17th, 1932 ," *The Bank of Nova Scotia Archives*, Secretary's Department Papers 1, File 61.
[535]Apparently Graham Towers believed one of the conditions of Clark's appointment was the creation of a central bank. *Interview*, Ottawa, 3 June 1982.
[536]Cited in H. Blair Neatby's *William Lyon Mackenzie King: 1932-1939 The Prism of Unity*, (Toronto and Buffalo: 1976), p. 58.
[537]P.C. 1562, 31 July 1933. The terms of reference called for "the study of the entire monetary system of Canada including credit, currency, and coinage, particularly in their relation to commodity price movements and fluctuations in international exchange." Also the Commissioners were asked to "consider whether and in what respects the banking

As astute political obsevers noted, the commission's composition, mainly bankers, was designed to assuage bankers' fears and to ensure the recommendations would be acted upon. [538]

In presentations before the Commission in August and September 1933, bankers predictably opposed a central bank, arguing instead for an Administrative Board of financial experts from agriculture, commerce and industry to oversee monetary affairs independently.[539] Academics, farmers and prairie governments were nearly unanimous in their support for a central bank. Hopeful farmers looked to the bank for a return to rising commodity prices.[540] After two months studying the Report, Bennett announced that legislation would soon be introduced to establish a central bank. The bill, primarily the handiwork of W.C. Clark, was introduced in February of the following year and given royal assent on 3 July 1934. The recruitment of Canadian Graham F. Towers, then Assistant General Manager of the Royal Bank of Canada and a career banker, can be seen as another move by the Government to ensure co-operation with the banks and to placate xenophobic fears about a Bank of England conspiracy.

Interest Rates

A survey of documents on deposit at The Bank of Nova Scotia Archives, Bank of Canada Archives and the Public Archives of Canada indicates that the most frequent topic of discussion between banks and government involved the rates paid on government issues and on savings deposit rates. Government bonds and savings deposits represented the banks' second largest asset and liability, respectively. The survey shows that before the creation of a central bank, the Government was compelled to negotiate *directly* with the banks over the price, term, amount, and rate for refunding maturing debentures. This consultation was required insofar as the chartered banks were the largest holders of these

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[537](cont'd)institutions and the monetary system in Canada can be modified, extended or developed for the purpose of fulfilling intra-imperial and international cooperation in public policies designed to promote the revival of domestic and foreign trade and enterprise and the general increase of employment and to ensure a greater measure of stability in respcet thereto." Moreover, the Commissioners were advised that the advisability of establishing a central bank was also within their mandate.

[538]"Ottawa Confirms Macmillan Acceptance," *The Financial Post*, 5 August 1933, p. 1.

[539]Testimony of C.B.A. President J.A. McLeod, *Proceedings*, Royal Commission on Banking and Currency, Ottawa, 14 September 1933, pp. 3231-3232.

[540]See A.F.W. Plumptre, "The evidence presented to the Canadian Macmillan Commission," *Canadian Journal of Economics and Political Science*, Volume 2, No. 1, (March 1936), pp. 54-67. Paradoxically, some western academics including Swanson from Saskatchewan opposed a central bank.

obligations. Therefore it was incumbent on the Government to ascertain that the banks would take up a large portion of a maturing issue. We shall argue that the huge portfolios of maturing Dominion bonds gave the banks a considerable degree of leverage over the setting of interest rates to coincide with the banks' expectations and not the Government's desires.

The public loan issued in December 1931 is one example of a drive for higher yields. The "Toronto General Managers" (Imperial, Nova Scotia, Commerce, Dominion and Toronto) felt a 4.5 per cent coupon issued at a discount would not sell as well as a five percent bond at par.[541] Such an indication from a major segment of the buying population was likely to constitute a significant influence on the market price of the securities. To be sure, the bankers' reading of this particular situation was not unrealistic for the average yield of long-term Canadas rose from 4.3 per cent in August to slightly above five per cent in December. The bonds were issued with a five per cent coupon on this occasion.

At a meeting in September 1932 an effort to increase prices by monetary means and to show an increasingly desperate population that something was being done, was attempted. Edgar Rhodes arranged an increase in advances to the banks under the *Finance Act*.[542] Under the agreement, the banks would lend the Government $35 million at 4 per cent to be discounted for Dominion Notes at 2.5 per cent. This proposal was reluctantly accepted by the bankers who objected "on the ground that they had more money in their tills now than they could find good risks for, Leman expressing the view, which was concurred in by the others, that the ratio of depositors to borrowers at the present time was about five to one."[543] Rhodes evidently was worried about financing "as cheaply as possible, *and with as little embarrassment as was inevitable in connection with a large transaction.*"[544] Sellar reiterated the Dominion desire for lower rates and monetary expansion by introducing the possibility of a political backlash should the banks not fall into

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[541] J.A. McLeod to H.T. Ross, 13 October 1931, *The Bank of Nova Scotia Archives*, Secretary's Department Papers 1, File 61.
[542] Watson Sellar, Memorandum to File: Meeting in Committee Room, Bank of Montreal," 27 September 1932, *Public Archives of Canada*, RG 19, Volume 592, File 155-30. This operation is known as rediscounting in which the banks pledge a security to the Government in exchange for bank notes thereby increasing their cash reserves and, as a result, their commercial loan portfolios. In this instance the Government issued the securities which were then rediscounted under the Act.
[543] *Ibid.*
[544] *Ibid.* (emphasis added). This statement makes some sense in light of the criticisms made by Eugene Forsey noted above.

line. According to the Canadian Bankers' Association record:

> The Comptroller of Finance suggested the original proposal for three-year treasury bills would enable the banks to borrow on them under the Finance Act, thus providing a showing of increased advances *which would be some answer to the demands in the west and elsewhere*, particularly since the publication of the report of the Monetary Committee of the Imperial Conference recommending an increased supply of cheap money as a means of raising commodity prices. *Otherwise at the forthcoming revision of the Bank Act there would most certainly be a controversy over the utilization of the Finance Act.*[545]

The foregoing shows a rather cynical attitude towards the politics of banking legislation, a predeliction towards symbolism in political matters, and lastly the blurring of political and administrative roles. Unfortunately, for the Government, the banks interpreted advances as a sign of weakness (why this was not the case in 1928-29 is a good question) and consequently other outstanding advances were drawn down making the effect on credit expansion negligible. Between December 1932 and April 1933 advances declined from $59 million to $39 million. Some analysts, including S.R. Noble, Assistant General Manager of the Royal Bank, believed this action put a halt to further loan liquidation, but the lack of satisfactory loan demand still did not encourage the expansion of loans and investments.[546] Table 6.2 however does not bear this out as loan liquidation proceeded until 1936. It is true however that the banks' note supply did not decline after 1932 and by 1934 total bank assets began to grow slowly.

In reviewing the Government's abortive attempts to compel the banks to increase their cash reserves and their commercial loans, Governor Towers observed:

> If it seemed desirable to encourage expansion there was no way for the Government to take the initiative. It is true that an exception to this rule is found in Mr. Bennett's action in November of 1932 when he persuaded the banks to borrow $35 millions under the Finance Act. No more satisfactory way of accomplishing his purpose was open to him. But the very fact that such a transaction had to take place made it obvious that a central bank must be organized in Canada.[547]

Ultimately the banks did agree to the terms provided that the proceeds of the fall loan would be used to repay this short-term loan.

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[545]Enclosure to C.B.A. Circular 94-Y dated September 29, 1932: "Minutes of Conference with Minister of Finance at the Bank of Montreal, Tuesday, 27 September 1932, *The Bank of Nova Scotia Archives*, Secretary's Department Papers 1, File 61. (emphasis added)
[546] "The Monetary Experience of Canada during the Depression," *The Journal of the Canadian Bankers' Association*, Volume 45, No. 3, (April 1938), p. 274.
[547]Towers Memoranda, No. 254, 4 May 1939, "Reply to Dr. Donnelly's Questions in the House," p. 4. *Bank of Canada Archives*.

In 1933 negotiations for the sale of treasury bills floundered over price/yield. Minister Rhodes was seeking a 3.5 per cent rate. However "It was pointed out that the banks were giving to the Government the full benefit of the reduction of 1/2 of 1% in interest on deposits, so that there should be no criticism of a 4% rate. It was also pointed out that the prevailing market rate for long-term government issues was between 4 1/4% and 4 1/2%, so that a rate of 4% on treasury bills would not be out of line." [548] Here again the bankers also got their way.

This *in camera,* personal, non-arms-length financial relationship was most visible during negotiations surrounding the refunding operations of October 1934. At the end of July the President of the Association, Jackson Dodds, and the Prime Minister debated interest rates over the phone. Bennett insisted the Government could not afford 3 per cent, anything in that range would have an adverse effect on the Government's autumn financing plans.

> Mr Bennett reiterated this over and over, and said the country and the banks must swim or sink together. Mr. Dodds pointed out the danger of bringing down the interest structure too fast and while admitting this Mr. Bennett still said that the Government could not pay 3 % in this instance. [549]

Dodds then went on to point out that the 2.75 per cent rate would be unprofitable to the banks and lead in turn to a reduction in bank dividends, to a further undermining in confidence and to a weakening of the country's credit standing. It would appear that the credit-worthiness of the state and the banking system were inexorably linked, at least according to the Prime Minister and the President of the Bankers' Association.

Tied to the question of interest rates and bank profits was the issue of rates paid depositors -the banks' major liability, representing over 50 per cent of the system's liabilities. Given a clear desire on the part of the Government to force interest rates down and thus lower its own financing costs, plans were laid to reduce interest paid to depositors. In the Spring of 1933, a statement was made to the House by Rhodes detailing the Government's reasons for lowering deposit rates on Post Office Savings Bank accounts.

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[548] C.B.A. Circular 104-F, 27 May 1933, *The Bank of Nova Scotia Archives*, Secretary's Department Papers 1, File 61.

[549] Enclosure to Confidential letter, A.W. Rogers, Secretary, C.B.A. to H.F. Patterson, General Manager, dated 25 July 1934: "Memorandum of telephone conversation between the Prime Minister and Mr. Jackson Dodds, 25 July 1934," *The Bank of Nova Scotia Archives*, Secretary's Department Papers 1, File 57.

> However, believing that it was of the utmost importance to business and trade generally that interest rates should be lowered, the government has reduced the interest rate paid on post office savings bank deposits by one-half of one percent effective May 1, thereby co-operating in the general program to lower interest rates paid on savings deposits by the chartered banks and other depositories in Canada. The government participated in this matter to lay the ground for an effective reduction in the cost of money to all classes of borrowers and to promote the stimulus to business recovery which would result therefrom.[550]

In typical fashion, the Finance Minister intimated that the Dominion Government itself was somehow indifferent to the level of interest. This obfuscation hid the fact that the Dominion was then actively pursuing with the bankers a policy of driving rates downward to keep a lid on its own interest costs.

During the Autumn 1933 financing discussions, Government officials again sounded out the banks on the conversion of maturing obligations. Questions were raised about the 4 per cent coupon rate which might be discounted to yield 4.5 per cent, the market rate.[551] From the standpoint of public psychology and public relations, only a 4 per cent coupon rate would do. It might be remembered that several parliamentarians in the spring session pressed the Government to commit itself to a cheap money policy. Cheap money meant a "good deal below 4 per cent" for H.E. Spencer.[552] In return for this 4 per cent concession, Bennett agreed that all conversions would be effected through the banks and for new cash sales "the general presumption would be that the bond dealers were to deal through the banks." [553]

The following July, Edgar Rhodes and W.C. Clark met with C.B.A. representatives. Clark put forward the Government's position that unless interest rates were brought down immediately, "there would develop a strong public attitude in favour of repudiation and scaling down of debts."[554] In response, Dodds held that interest rate sensitive money would

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[550]House of Commons, *Debates*, 17th Parliament, 4th Session, 11 May 1933, p. 4854.
[551]C.B.A. Circular 108-Q, 16 September 1933, *The Bank of Nova Scotia Archives*, Secretary's Department Papers 1, File 61, "1932, 1933 Government Financing."
[552] House of Commons, *Debates*, 17th Parliament, 4th Session, 11 May 1933, p. 4856.
[553]C.B.A. Circular 108-X, 2 October 1933, Enclosure entitled: "Minutes of Conference held in Ottawa, Wednesday September 27, 1933 with the Right Honourable R.B. Bennett, Prime Minister Relative to the forthcoming Conversion Loan," *The Bank of Nova Scotia Archives*, Secretary's Department Papers 1, File 61. Financing."
[554] A.W. Rogers to H.F. Patterson, General Manager, 20 July 1934, Enclosure: "Minutes of a Meeting of the Minister of Finance (Hon. E.N. Rhodes) and Deputy Minister (W.C. Clark) with the President and Senior Vice-President of the Association, held in the Office of the Minister at Ottawa, on Thursday July 19th, 1934," *The Bank of Nova Scotia Archives*, Secretary's Department Papers 1, File 57.

leave the country adding that, in his opinion, "there was a still greater necessity for the balancing of budgets and in the case of the Dominion the real problem was the railway problem which Mr. Rhodes readily admitted."[555] In order to resolve the impasse it was arranged to have the banks lower their savings deposit rates to two per cent from 2 1/2 per cent. The Government also agreed to "use their best endeavours to induce trust and loan companies to reduce their rate....." [556] Several months later as the Autumn financing approached, the Minister requested a meeting with the Association to confirm this understanding. This meeting followed discussions between bankers and trust company officials on September 21 at which time an agreement was struck to reduce trust company savings rates effective February 1, 1935. This arrangement however was not entirely satisfactory to the banks. According to the C.B.A. record of the meeting:

> The President felt that it was possible (reduction of rates) and stated that while the banks did not desire to take any drastic action, they would try to get all organizations in line. He felt that the trust companies should be asked to undertake to accept no new deposits at the present rates, and that such deposits should only be accorded the rates which would be generally effective in January next. Mr. Clark felt there would be no difficulty about this. The President asked Mr. Clark to telephone to representatives of the trust companies after two days. After further discussion it was agreed that Mr. Clark should ring Mr. Watson of the Toronto General Trusts Corporation about 11 a.m. on September 25th. The President also asked Mr. Clark to telephone the Montreal City and District Savings Bank. [557]

By this non–market arrangement, the lowering of financing costs to the Government was transmitted through the banking and financial system reducing markedly the interest paid depositors. The Government's desire to reduce its borrowing costs therefore placed it in the awkward position of acting as an intermediary to bring other financial institutions "into line". Public policy of forcing down interest rates was made congruent with the private desire to maintain existing profits levels and the "market share" of deposit–accepting institutions.

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[555] *Ibid.* It should be pointed out that the C.P.R. was one of the Bank of Montreal's largest corporate clients, if not their largest client.
[556] *Ibid.* p.8.
[557] C.B.A. Circular 120–P, "Minutes of a Conference Held at the Request of the Minister of Finance at Ottawa on Monday 24th September, 1934 relative to the forthcoming conversion loan," *The Bank of Nova Scotia Archives*, Secretary's Department Papers 1, File 57.

After 1935- Changing the Rules of the Game

We have observed how the banks negotiated directly with the supposedly sovereign Dominion Government to obtain a high yield preferably distributed in short-term tranches. While the banks pointed to "market prices" in justifying certain yields, it must be remembered that the banks themselves stood at the centre of this market alongside insurance and trust companies, many of which were closely associated through historical inter-corporate ownership.[558] It was the "salaried trustees" who liquidated or reduced bond holdings in response to manifestations of "bad faith" by governments or socialist/ social credit musings. This acute sensitivity, often bordering on hysteria, could be counter-productive to dealers and borrowers entering the market. One of the primary functions therefore of the Bank of Canada was to take a medium or long-term view of the market and to stabilize short-term price fluctuations caused by knee-jerk reponses to political and financial developments at home and abroad.[559] The second unstated function performed by the central bank was to reduce the banks' influence upon borrowing operations and, it may be deduced, influence on general economic policy.

During the initial phase of the Bank's operations, relations between the Bank of Canada and the banks could be characterized as cordial but not cosy. The cordiality warmed as Towers proffered sound advice to bankers on the Alberta situation. This early crisis was a singular challenge to both the federal government's constitutional authority and to the Bank's financial hegemony. The ensuing collaboration of convenience to defeat Aberhart was lessened during the war as the Bank used its new-found market muscle to foist government loans on the banks at very low rate. After the war, relations normalized although the banks' former independence in making commercial loans was soon challenged.(Section (vi) below)

Weaning banks away from routine, past behaviours, that is of the privileged access previously enjoyed was a slow process. Correspondence between Towers and Clark over the Bank of Montreal's usage of the term "fiscal agent of the Government of Canada" in London was one case in point. In September 1935, the Governor suggested amending the Montreal's title to "paying agent".[560]

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[558]For instance the Canadian Bank of Commerce-Canada Life-National Trust empire of George Cox and the Royal Bank-Imperial Life-Montreal Trust empire of Sir Herbert Holt.
[559]See Neufeld, 1958, pp. 42-45.
[560]G.F. Towers to W.C. Clark, 4 September 1935, *Public Archives of Canada*, RG 19,

No formal response was received from Clark until Towers raised the issue two years later. Towers was particularly opposed to the Bank of Montreal using this title for advertising purposes.[561] Clark's non–committal reply expressed agreement with the basic complaint, "but I do not think," wrote Clark, "we can make any change for some time."[562] This exchange is one illustration of the Government's reluctance to raise an issue of privilege which gave one bank a distinct advantage over other Canadian banks operating in London.

The Montreal's influence in the early post–Bank era is demonstrated in correspondence between Finance Minister Dunning who later became a director of that bank and Jackson Dodds, General Manager of "Canada's First Bank". In the Fall of 1936, Dodds sought a return to the previous regime of distribution which favoured conversion holders over new subscribers. Dodds also recommended the institution of a 5 per cent deposit for subscriptions to discourage "padding" and a longer period for the taking of subscriptions, steps the central bank soon acted on. In explaining his bank's position, Dodds wrote:

> it would seem likely that at some time within a reasonable period before the due date the holder will realize upon his maturing securities so long as a premium exists and in doing so *if large holdings are involved* the price level on short–term securities is bound to be affected to the disadvantage of the borrower.[563]

Dunning, in reply, stated that it would be unacceptable to allow holders two opportunities to convert their holdings. Instead the converters would be given preferential treatment *but only once.*[564] Dodds' prompt response highlighted the Montreal's vast market power, its preference for a short–term tranche, and the certainty of its conversion privileges.

> It is perhaps worth noting that of the total conversion of $135,000,000 obtained by the Government in June the Bank of Montreal produced $44,000,000, that is, about one third. We fully realize that in converting $43,000,000 of our own bonds out of a total of $78,000,000 maturing we were running the chance that such issue as the Government would see fit to offer in the autumn loan, whatever the term might be, the principle of giving preference to the holders of maturing bonds would still govern.[565]

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[560](cont'd)Volume 234.
[561]G.F. Towers to W.C. Clark, 17 December 1937, *Public Archives of Canada*, RG 19, Volume 234.
[562]W.C. Clark to G.F. Towers, 24 December 1937, *Public Archives of Canada*, RG 19, Volume 234.
[563]Dodds to Dunning, 20 October 1936, *Public Archives of Canada*, RG 19, Volume 589, File 155–0–97.
[564]Dunning to Dodds, 26 October 1936, *Public Archives of Canada*, RG 19, Volume 589, File 155–0–97.
[565]Dodds to Dunning, 28 October 1936, *Public Archives of Canada*, RG 19, Volume 589, File 155–0–97.

Here Dodds took care to remind the Minister of the extent of his bank's market power, at that time much greater than the fledgling Bank of Canada. While agreeing with the Dominion's policy of funding, Dodds proposed that preference still be given to subscribers "who might indicate that they proposed paying for the new issue by surrendering the old."[566] In order words, giving to those that have, special status.

From the banks' perspective in general, knowledge that a follow-up conversion would take place gave the holder greater flexibility. If rates were expected to fall, the bank could convert most of their holdings at existing rates. Or, by holding on to the higher yielding paper, the banks could dispose of the bonds at a premium before maturity. Should rates be expected to rise, banks would simply hold on to the securities to avoid dumping bonds on a declining market at a loss and then convert to a new, higher rate. In fact, during the summer of 1936, rates did fall so that those holding on to bonds saw their prices rise.

From a governmental-debtor perspective preferential treatment meant issuing short-term bonds to banks in exchange for maturing paper. This vitiated their goal of extending the term to maturity of the debt.[567] Towers felt if the Bank of Montreal knew no second conversion offer would be given, it might have sold its large holdings on a rising market at a profit thus destabilizing market conditions.[568]

While this particular episode may be taken as special pleading of one, major participant, it does reveals the bankers drive for yield and liquidity (conversion opportunities). These requirements do come into play for all banks who would benefit from knowledge of the Bank and Government's intentions in the field of debt management.

From March 1935, the chartered banks were excluded from the planning and preparation of bond issues. Meetings organized between the general managers and the Governor and Bank officials– direct discussions with Clark and the Minister were unusual– dealt with credit policy, international and domestic financial and political events, never specifically on debt management policy. At their semi-annual meeting in November 1937, the banks desire for liquidity was again in evidence. Sydney Dobson asked what the bank's

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[566] *Ibid.*
[567] Dunning to Dodds, 31 October 1936, *Public Archives of Canada*, RG 19, Volume 589, File 155-0-97.
[568] "Memorandum of Conversation with Mr. Jackson Dodds," 8 October 1936," *Bank of Canada Archives*, DG 400-Dominion Government Financing, 1935-1937.

"attitude" was with respect to the purchasing of treasury bills. Towers responded that the Bank would discount treasury bills presented at the bank rate as provided under the *Bank of Canada Act* but was unwilling to give a *carte blanche* commitment. Towers also used the occasion to announce that the 14 day mimimum on central bank advances would be reduced to seven days. "This concession," wrote Towers, "evidently pleased the bankers very much."[569] These matters related directly to credit policies and the level of cash reserves and only tangentially to debt management. Thus after 1935, the state had moved 180 degrees from a regime in which the banking fraternity had a profound influence on debt management, to a system in which the central bank exercised the powers formerly held by private institutions.

Canadian Federalism and Banking

Soon after the initial legislative programme of the Social Credit government became known in April 1936, the C.B.A. solicited the views of Graham Towers and Clifford Clark on the crisis.[570] In May, Towers advised the banks that they should seek representation on the Bondholders' Committee and participate actively in its activities.[571] In June, Clark's ideas were tapped. Initially, the deputy felt "Section 138" [572] ought to be applied on the matter of "prosperity certificates". Clark later expressed some reservations about disallowance, suggesting the Province should "learn from actual experience that it (dated scrip) could not be operated successfully."[573] Both Towers and Clark felt that banks would be well-advised not to accept these certificates with Towers advising that the "practical difficulties" be stressed.[574]

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[569]Towers Memorandum, No. 77, 23 November 1937, "Governor's conversation with bankers in Toronto, 18 November 1937," *Bank of Canada Archives.*

[570] Initiatives included *The Social Credit Measures Act* which empowered the provincial cabinet "to put into operation any measures designed to facilitate the exchange of goods and services or any proposal which is calculated to bring about the equation of consumption to production and thus to ensure to the people of the Province of Alberta the full benifit of the increment arising from their association." *The Provincial Loans Refunding Act* authorized the cabinet to negotiate with bondholders a reduction of interest and acceleration of maturities. During the Fall Sitting of the Legislature, legislation was passed to establish social credit, reduce payments on outstanding debts, and to cut by one-half all interest payments on municipal and provincial and provincial guaranteed debts.

[571]C.B.A. Circular 157-A, 30 May 1936, *The Bank of Nova Scotia Archives*, Secretary's Department Papers 1, File 153.

[572]Presumably disallowance or Section 90.

[573]C.B.A. Circular 158-H, 19 June 1936, *The Bank of Nova Scotia Archives*, Secretary's Department Papers 1, File 153.

[574]*Ibid.*

On September 1, the Lieutenant-Governor gave royal assent to several bills including *The Reduction and Settlement of Debts Act*[575] and *The Debt Adjustment Act*.[576] The former act limited interest and principal owed after 1932 while the latter established a Debt Adjustment Board whose arbitration decisions between debtors and creditors were deemed to be final. In response to this massive intrusion into the sphere of contract law, the C.B.A. retained counsel in Edmonton (H.R. Milner), Toronto (W.N. Tilley), and Montreal (R.C. McMichael) to prepare the banks' case against provincial intrusion into the sphere of credit and banking. In a sixteen page "draft brief" to the Governor in Council requesting disallowance of these acts, the Dominion was urged not to construct too narrow a view of its powers and overriding responsibilities for "peace, order, and good government."

> ....it is apparent that the question of Dominion intervention by way of disallowance or a reference to the Supreme Court of Canada does not rest solely upon the constitutional validity of the Alberta legislation, *but upon the serious consequences to the citizens of Canada as well as to Confederation itself, if a unit of Confederation is permitted to evince such disregard of contractual obligations, of fundamental rights, of the stability of financial institutions, and of the very terms of Confederation as crystallized in the British North America Act.*[577]

In sum, the public good was reduced to the preservation of the existing financial order and the constitution and common law which established the rights and obligations of debtors and creditors. Underpinning the banks' case was the assumption that any violation of the sanctity of contract would harm the general public much in the same way as a supply side economist imagines benefits to the rich trickling down to the workers.

The gravity of the situation in the winter of 1936-37 is apparent when examining the various alternatives circulating through C.B.A. offices at that time. These proposals included "intimation" of a lower deposit savings rate for Albertans or an actual reduction, "turnover charge", as well as "lending at the current rates of interest, by way of discount wherever possible."[578] However these proposals were not universally endorsed. The Nova Scotia's H.F. Patterson called these reductions "inadvisable and impolitic."[579]

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[575] 1 Edward VIII, (Second Session), Statutes of Alberta, 1936,Chapter 2.
[576] 1 Edward VIII, (Second Session), Statutes of Alberta, 1936, Chapter 3.
[577] A.W. Rogers to H.F. Patterson, General Manager, The Bank of Nova Scotia dated 6 October 1936, Enclosure: Draft brief to Governor General in Council re. disallowance, 6 October 1936, p. 16, paragraph 24, *The Bank of Nova Scotia Archives*, Secretary's Department Papers 1, File 153. (emphasis added)
[578] C.B.A. Circular 162-T, 25 September 1936, File 153 and A.W. Rogers to General Manager, 15 March 1937,*The Bank of Nova Scotia Archives*, Secretary's Department Papers 1, File 158.
[579] A.W. Rogers to General Manager, 30 June 1937, *The Bank of Nova Scotia Archives*,

Yet by July, despite some internal resistance, ads were being readied for the press to announce the reduction effective 1 August 1937. Only the wise counsel of the Bank of Canada's Governor served to postpone a move which, at this time, would surely have been "impolitic" and would have been perceived by Albertans as intimidation. When conferring with General Managers in July 1937, Towers expressed "surprise at hearing this for the first time, and pointed out how awkward a situation might have been created if our first news had been from some reporters who enquired what we thought of the new development."[580]

This proposal was abandoned only to resurface a year later after more Social Credit legislation designed to raise bank taxes dramatically. The Nova Scotia's Patterson stood by his earlier position, arguing

> it would be inadvisable for the banks to take steps to recoup themselves in any particular province for excessive taxation levied by it. We feel that whatever explanations the banks may make, they rather than the Government would be the target of public criticism and it is still our opinion that to take retaliatory measures in Alberta would only provoke reprisals on the part of the Government.[581]

Studies by Kwavnick and Bucovetsky on Canadian interest group behaviour have shown how certain group's lobbying efforts are directed either at the provincial or federal levels and this behaviour is a function of the division of powers.[582] This hypothesis would suggest that federally chartered banks would focus their efforts on influencing *Dominion* as opposed to provincial, decision-makers. It may also be hypothesized that the regulator may encourage industry/interest group behaviour which *supports* the existing distribution of constitutional powers. [583] When learning of a second move to lower deposit rates in the summer of 1938, Towers cautioned S. B. Dobson, C.B.A. President to "think twice" before embarking on such a course. The reasons for so doing are outlined below.

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[579](cont'd)Secretary's Department Papers 1, File 158.

[580]Towers Memoranda, No. 56, 12 July 1937, "Visit to Toronto, Meeting with General Managers, 7-9 July 1937," *Bank of Canada Archives.*

[581] H.F. Patterson to President Dobson, 14 April 1938,*The Bank of Nova Scotia Archives,* Secretary's Department Papers 1, File 159.

[582]David Kwavnick, "Interest Group Demands and the Federal Political System: Two Canadian Case Studies," in A. Paul Pross, *Pressure Group Behaviour in Canadian Politics,* (Toronto: McGraw-Hill-Ryerson, 1975), pp. 69-86 and M.W. Bucovetsky, "The Mining Industry and the Great Tax Reform," in Pross, pp. 87-114.

[583]At a November 1937 meeting with bankers, Towers expressed the sentiment that if Alberta was at all successful in the courts the Cabinet *should* move to disallow the legislation. Towers Memoranda, No. 77, 23 November 1937, "Governor's conversation with Bankers in Toronto, 18 November 1937," *Bank of Canada Archives.*

> the banks should fight on the line that *there was one banking system for Canada,* and that the terms of business should be approximately equal throughout the Dominion. That does not mean, for example, that loaning rates must be the same in the case of all borrowers, but there should certainly be no dividing line as between one province and another............. I mentioned that Mr. Dunning was generally in agreement with what I said to this point, and then went on to say that if the banks consistently fought on the line of Dominion–wide banking, so to speak, *the Dominion must inevitably protect them in the event of an emergent or an intolerable situation developing*– unless the Dominion abrogated its responsibility for banking, a surrender which I did not believe could take place.[584]

In short, the central bank's institutional interest sought to maintain the constitutional and financial status quo. The central bank's role in preventing what might be termed a colossal blunder enabled the banks to retain their credibility with the Dominion. This contact and unity of purpose to protect the federally–regulated banking system allowed the chartered banks to put forward a united position to the Alberta Government.

In summary, the available archival materials confirm the hypothesized collaboration between the federal regulator and a federally regulated industry. This co–operation was not founded solely on shared attitudes about the constitutional status quo. Equally basic to this alliance was their shared commitment to the sanctity of contract between lenders and debtors, the principle of interest determination through the financial marketplace, and the potential harm to Canada's credit should the Social Credit dream or delusion be realized. As will be shown in Chapter VIII, there were also very powerful *international* factors at work in the form of *expectations* that responsible finance officials, both private and public, should act together to thwart the actions of the unruly, former Calgary high school principal.

Deposit Certificates: 1940-1948

One of the principal objectives of this study is to show that the state's largest creditors, the chartered banks wielded considerable influence over the rate paid for loans. This positional power based on their deposit–accepting capabilities and vast securities holdings gave bankers unparalleled access to political and administrative decision–makers. Records examined show that bankers met three to four times per year with government officials prior to the Bank of Canada's formation. After March 1935, meetings were less

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[584]Towers Memoranda, No. 151, 22 June 1938, "Telephone Conversation with Dobson, C.B.A..", pp. 1,2, *Bank of Canada Archives*. (emphasis added)

frequent although contact was high during the war through the medium of the National War Finance Committee chaired by a banker, George Spinney.

This hypothesized relationship changed during the War when the relative power of the state and the banks shifted in favour of the state. The main source of conflict between the banks and the Government and central bank was over the sale of *deposit certificates*. Because of the timing difficulties associated with War and Victory Loan campaigns, the Government required bank financing to meet its short-term cash requirements but dreaded the inflationary consequences. The initial idea for deposit certificates was formulated by the Department of Finance, the policy-making unit and executed by the Bank of Canada. The "DC" was modelled after a low-yielding, short-term instrument employed by the British Treasury and sold to the banks at the outset of the conflict. In Canada, there appeared initially a genuine difference of opinion between the Governor and the Finance Department over what a suitable rate of interest might be on these short-term instruments. At a meeting on 6 December 1940, the central bank's opposition was based on an assumption that the chartered banks must earn a profit on their dealings with the Government. As things transpired, this was not what Finance Department officials necessarily had in mind. Towers' record of the meeting reflects this misunderstanding.

> ....we pointed out that a 1 1/2 per cent basis allowed the banks a gross profit of a little more than 3/8 of 1 per cent. This figure was arrived at after an estimate of .9 percent, covering interest which the banks would have to pay on deposits which channeled through to savings accounts (assuming that 60 per cent of the money got into savings accounts and that the savings rate was 1 1/2 per cent). Allowance was made for the cost of carrying cash reserves of 10 per cent. The profit, therefore, of 3/8 plus per cent would be reduced by additional expenses incurred by the banks in dealing with an additional $250 millions in deposits. While we stated that the 1-1/2 per cent basis seemed as low as one could fairly ask the banks to go, I stated in response to a questioning attitude by Clark, that if he could persuade the banks to a better deal- fine. But we would not argue for it.[585]

Several months later, Towers again went on record as being opposed to any scheme which would "foist on the banks "additional non-earning assets.....which they would have the expense of deposit interest and so forth. The proposal would, therefore, mean a discriminatory tax on the banks which they would have to pass on to their depositors, shareholders or employees. I do not believe that one could justify a discriminatory tax of

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[585]Towers Memoranda, No. 370, 6 December 1940, "Conversation with Clark, MacFarlane, Johnson, Gordon," *Bank of Canada Archives*,

this kind by any saving in interest costs which it might achieve."[586] Yet with the approach of conscription in 1942, it was decided to go ahead with this daring proposal. That July, Towers sounded out the idea with chartered bankers who, predictably, were not favourably disposed to the plan. According to the record kept by Vernon Knowles, the Association's Public Relations Adviser, the Government was "out of cash" and needed $500 million between July and the October financing (Third Victory Loan).[587] Towers proposed a new, fully registered, short-term, interest bearing instrument to be allocated on the basis of the increase in bank demand (chequable) deposits. This security would "freeze" bank assets by the proposed $500 million indefinitely and would be *inconvertible*. The Government's commitment to buy back these securities was given only if the primary distribution among the banks was wrong. Towers admitted candidly that the practical effect of the measure was to have the banks loan the government money at 3/4 per cent for an indefinite period.[588] Sydney Dobson and S.H. Logan expressed worry that this low cost Dominion financing "would affect the borrowing desires of every province, Mr. Dobson observing that every province would want a reduction in its interest rate."[589] Towers deflected these arguments by evoking the inflationary "remedies" advocated by some politicians and citizens. "The pressure on the Government to finance through the Bank of Canada," Towers is reported to have stated, "is quite heavy. Of course there is not any prospect in the near future of the Government cracking in on it but to the layman it looks so easy. He doesn't really understand the evils of such a course."[590]

Still, the bankers were not easily convinced. They understandably wanted to hold a *marketable*, negotiable instrument which could be readily disposed of and Towers, it seemed, was unwilling to provide any undertaking not to press for renewal of these low yielding instruments. The low, punitive rate was also disturbing. "Mr Logan observed," the C.B.A. record reads, "that once a low rate is set it would be impossible to get it back up

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[586]Towers Memoranda, No. 379, 19 March 1941, "Notes for Speech by Ralston," *Bank of Canada Archives*.
[587]C.B.A. Confidential letter, A.W. Rogers to H.D. Burns, General Manager, The Bank of Nova Scotia, dtaed 21 July 1942, Enclosure: "Memorandum of Meeting with the Governor of the Bank of Canada on July 20, 1942 prepared by the Public Relations Adviser, Board Room, Bank of Canada, Ottawa, 10:30 a.m.," p. 2, *The Bank of Nova Scotia Archives*, Secretary's Department Papers 1, File 58.
[588]"Summary of Discussions with Governor Towers, 21 July 1942, Enclosure to C.B.A. Confidential Letter, A.W. Rogers to H.D. Burns, General Manager, p. 2, *The Bank of Nova Scotia Archives*, Secretary's Department Papers 1, File 58.
[589]*Ibid*, p. 5.
[590]*Ibid*.

again. All governments are going to have to borrow more and lean upon the banks more in the future at as low a rate as they could get."[591] Towers reiterated his expectation that the banks too should be willing to make sacrifices for the cause. He then went on to say "If during the war our entire relations with the banks could be shown to be fair to both sides, not representing an undue cost to the Government and enabling the banks to get along without resultant war profits, that would be desirable."[592]

This dispute was finally settled at a meeting between Finance Minister Ilsley and members of the Association a week later in Ottawa. At the meeting, the main bone of contention was the rate of remuneration, the question of the non-negotiable character of the deposit certificates had apparently been agreed to. Rates charged the Government were based on the imputed cost of deposits or liabilities of the banks. The Government believed the rates to be .55 per cent, while the C.B.A. claimed their deposit costs to be considerably higher and therefore desired a higher return on these obligations. Finance Minister Ilsley rejected a rise in bank compensation on the grounds that it would "evoke from monetary experimenters in the House criticism not only of the Government but of the banks." Ilsley believed that the 3/4 per cent rate was being seen as a type of service charge which would satisfy the demand by some for bank loans *without interest* in a kind of a political compromise. [593]

Minister Ilsley and the Government could use the spectre of radical demands of monetary experimenters as leverage during discussions due to the the political situation in early 1942. In his "Address in Reply to the Speech from the Throne" in January 1942, C.C.F. leader M.J. Coldwell advocated the direct national control of all financial institutions, compulsory interest-free loans imposed on the accumulated savings of rich individuals and corporations as well as a 100 per cent excess profits tax.[594] A similar idea broached a year or so earlier by Keynes was known as a "compulsory savings plan." [595] An indication

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[591] *Ibid.*
[592] *Ibid.*
[593] C.B.A. Confidential letter, A.W. Rogers to H.D. Burns, General Manager, The Bank of Nova Scotia, dated 28 July 1942. Enclosure: "Memorandum of a Meeting of the Members of the Canadian Bankers' Association with the Minister of Finance at his Office, in the House of Commons, Ottawa, at 12 Noon, Monday July 27, 1942," *The Bank of Nova Scotia Archives*, Secretary's Department Papers 1, File 58.
[594] House of Commons, *Debates*, 19th Parliament, 3rd Session, 26 January 1942, pp. 55–56.
[595] "Mr. Keynes 'Compulsory Savings Plan'," *The Journal of the Canadian Bankers' Association*, Volume 47, No. 3, (April 1940), pp. 256–259.

that Coldwell's recommendations were seriously considered by the Government is revealed in a remarkable document prepared by Keynes' former student, R.B. Bryce. Bryce's recommendation for the establishment of controllers for banks, insurance companies and the like was premised on the belief that sacrifices should be spread equally or at least more equally between labour and capital. Noting that no formal controls had yet been imposed on capital, Bryce stated:

> *There is already a widespread feeling that there should be some form of conscription of wealth* in addition to the normal and orthodox forms of taxation, which are after all conscription of income rather than wealth. *If these demands for some application are not met sensibly they are apt to grow and to force later the Government into some radical action,* while in the mean-time creating a considerable amount of ill-will. Therefore I would suggest that in dealings with the problems of financing and of liquidity the Government should be prepared to invoke the principle of conscription of wealth as an instrument to attain certain ends, and also as having a value in itself at this time. [596]

It must again be remembered that the threat of armed services conscription loomed large at this time. While the policy alternative suggested by Bryce was never implemented, both Towers and Clark read the document and it is not improbable that Ilsley also glanced at the memorandum.[597] This memo indicates a readiness on the part of policy-makers at this time to consider a wide range of policy options. In wartime, previous taboos about interfering in markets had vanished opening up to the young policy-making group in Finance a broad range of questions and issue areas to examine. This document lends certain credence to the view that veiled threats, intimations, or suggestions did carry some force– they were not idle blusterings. During the War, the Dominion did seem prepared to overturn custom and "business as usual" to ensure the efficient financing of the war effort. It is quite probable that Clark circulated Bryce's radical tracts as trial balloons to provide the Finance policy-makers with room to fall back to a moderate stance.

Throughout the Fall and Winter of 1942-43, the banks petitioned the Government to reduce the volume of 'DCs' outstanding. In September, the Association President wrote Towers to remind him of their understanding that the "Dominion Government will make a very substantial reduction in the banks' holdings of these certificates from the proceeds of the forthcoming Third Victory Loan as soon as the funds are available."[598]

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[596]"Notes on 1942-43 Financing and the Conscription of Capital," 1 April 1942, pp. 2-3.
[597]Towers believed that the existing institutional arrangements did not require the creation of separate controllers. Towers Memoranda, No. 430, 1 May 1942, "Remarks on Mr. Bryce's Memorandum of April 1, 1942," *Bank of Canada Archives.*
[598]Quoted in letter, A.W. Rogers, Secretary, C.B.A. H.D. Burns, General Managers, The

The following February in correspondence leading up to a crucial meeting with the Governor, the Assistant General Manager of The Bank of Nova Scotia recorded his bank's displeasure about the existing state of affairs.

> it seems to us that the proper course for the Government to follow is to recognize the situation and replace the unpaid portion of the Certificates of Deposit with longer term obligations and bearing a rate of interest in keeping with the term, e.g., if a two year maturity were decided upon we would suggest a rate of 1 1/2%[599]

In sharp contrast to the 1930s, the banks now advocated the funding of the debt while government decision-makers wished to take advantage of the exceptionally low rates for short-term money. Crockett's proposal for negotiations betrays a certain nostalgia inasmuch as his recommendation presupposed that the Dominion would indeed listen to the banks. This was not the case during the War however.

The banks then not only opposed the non-marketable aspect of this forced loan but its yield which would have a depressing effect on profits. This concern led C.B.A. President St. Pierre to bring these complaints to Towers, who was more likely to be sympathetic than the Minister or Clark. The Government's cash requirements wrote St. Pierre should be funded "with an appropriate rate." He added "that the Government would not have to finance on such a substantial scale throughout the period contemplated if it did not act as banker for its war contractors."[600] Not only was the Government borrowing well below market rates; to add insult to injury it was taking lucrative commercial lending away from the banks!

In February 1943, the ceiling for deposit certificates agreed to the previous summer was more than doubled to one billion dollars. In return for holding these low-yielding instruments, it was suggested at a June 1943 meeting that the "banks should obtain a better rate on some other securities in compensation." There was general agreement among the assembled chartered bankers that the government should borrow "longer" and disappointment that the promised issue to banks of 1 1/2% bonds had been

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[598](cont'd)Bank of Nova Scotia, 10 September 1942, *The Bank of Nova Scotia Archives*, Secretary's Department Papers 1, File 58.

[599]Edwin Crockett, Assistant General Manager to C.B.A. Secretary [A.W. Rogers] 1 February 1943, *The Bank of Nova Scotia Archives*, Secretary's Department Papers 1, File 57.

[600]C.B.A. Confidential letter, A.W. Rogers, Secretary to H.D. Burns, General Manager, The Bank of Nova Scotia dated 11 February 1943. Enclosure: C.B.A. President to G.F. Towers, 9 February 1943, *The Bank of Nova Scotia Archives*, Secretary's Department Papers 1, File 58.

put off. [601] Yet, by early summer, a decision was taken by Clark to *increase* the volume outstanding. This set the stage for a heated exchange at the Mount Royal Club in June between the Governor, who delivered the bad news to the assembled bankers. The Royal Bank's Dobson expressed "shock" that the Government was not prepared to honour its commitment of February to issue a 2 year, 1.5 per cent bond. Eventually a compromise was reached which called for the sale of an additional $100 million in two year notes earning 1.5 per cent and maturing in September 1945.[602]

In December 1943, the Association President when broaching the question again of the low-yielding 'DCs' held by the banks was given a stern lecture on the benefits of low interest rates by Towers. The Governor stressed the "psychological effect" of a proposed reduction in the bank rate from 2 1/2 per cent to 1 1/2 per cent and intimated that if the banks preferred not to finance short-term government paper "on an appropriate basis, it would be necessary for us to go into the business ourselves by purchase and resale agreements with dealers." [603]

Governor Towers also used the issue of "bank profitability" on several occasions as leverage. When discussing the deposit certificate situation in July 1942 the Governor reminded bankers of their vulnerability with respect to bank profits. Given the atmosphere of wartime, claims that the banks were reaping huge profits would be valuable political fodder for the banks' enemies in Parliament. The banks had to be seen as co-operating, Towers asserted, adding "bank profits published and taxable were one thing and that the internal situation was another."[604] In another conversation with S.M. Wedd, Towers "expressed the view that the absolute amount of remuneration (for Victory Loans)

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[601]C.B.A. Confidential Letter, A.W. Rogers, Secretary to H.D. Burns, General Manager, The Bank of Nova Scotia, dated 19 June 1943. Enclosure: "Memorandum of a meeting between the Governor of the Bank of Canada and the General Managers of the Banks at the Mount Royal Club, Montreal on the afternoon of Thursday, June 17, 1943, *The Bank of Nova Scotia Archives*, Secretary's Department Papers 1, File 58. At a February 2, 1943 meeting bankers were led to believe that their request for a longer-term, 1.5 per cent issue would be forthcoming in July to redeem part of the maturing deposit certificates. G.F. Towers to W.C. Clark, June 1943, *Public Archives of Canada*, RG 19, Volume 606, File 155-80, Volume2.

[602] *Ibid.*

[603]Towers Memoranda, No. 459, 20 December 1943, "Conversation with S.M. Wedd, President of the Canadian Bankers' Association," *Bank of Canada Archives.*

[604] Summary of Discussions with Governor Towers, 21 July 1942, Enclosure to A.W. Rogers to H.D. Burns, General Manager, p. 8, *The Bank of Nova Scotia Archives*, Secretary's Department Papers 1, File 58. On this subject see also Towers Memoranda, No. 574, 1 September 1948, "Memorandum of conversation with Mr. Gillett, Bank of Toronto (acting for C.B.A.)," *Bank of Canada Archives.*

was getting too high."[605] At a meeting in February 1944 the Governor offered some "friendly advice" to the effect that it would be in the banks' own interest to provide improved financial reporting. "The public," Towers stated, believed "that the banks were tremendous money earners and that this view might impede proposals for the revision of The Bank Act," – hardly a subtle reference to the dicennial problems faced by the bankers during the Commons' committee hearings.[606] Towers also mentioned that it would be politic to reduce remuneration for Victory Loan campaigns by one-third for the banks' rising commissions were increasing "to a point where there was a possibility of embarrassment." [607]

As late as September 1948, with only $100,000,000 in deposit certificates outstanding, bankers still sought the elimination and/or increase in the yields of these instruments. The Towers' papers contain a memorandum of a conversation between the General Manager of the Bank of Toronto, Mr. Gillett and Towers on the subject of DC rates. The General Managers "were 'hot and bothered' by reason of the fact that they had simply received routine notices in regard to the renewal of the Deposit Certificate issue maturing September 3rd."[608] Towers tactfully reminded Gillett an arrangement had been made and the Government "was entitled to expect that it held good."[609] Towers then called Gillett's bluff by proposing to pay off the banks by reducing the Dominion's bank balances with the chartered banks which "from an earnings point of view would hardly do the banks much good." Gillett argued that it would not be "politic" to suggest the banks would not renew, but Towers insisted that the facts be put on record.[610] This last minute brinksmanship apparently paid off for the $100,000,000 in maturing certificates were renewed at 3/4 of one per cent, above the old 5/8 per cent yield.

In May 1944, the Governor of the Bank of Canada in testimony before the House Standing Committee on Banking and Commerce declared that "there was not any element

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[605] *Ibid.*
[606] C.B.A. Confidential letter, A.W. Rogers, Secretary to H.D. Burns, General Manager, The Bank of Nova Scotia, dated 17 February 1944. Enclosure: "Memorandum respecting a Meeting of Representatives of Chartered Banks with Governor of the Bank of Canada, Board Room, Canadian Bank of Commerce at 11 a.m., 14 February 1944," *The Bank of Nova Scotia Archives*, Secretary's Department Papers 1, File 59, p. 9.
[607] *Ibid.*, p. 13.
[608] Towers Memoranda, No. 574, 1 September 1948, "Memorandum of conversation with Mr. Gillett, Bank of Toronto, (acting for C.B.A.), *Bank of Canada Archives.*
[609] *Ibid.* This last minute request took place in Abbott's absence.
[610] *Ibid.*

of forced loans" insofar as the deposit certificates were concerned.[611] As argued above, this interpretation is certainly at variance with the records of a series of high level meetings that occured in 1942, 1943 and 1944 revealing the opposition of the banks to a reduction in the liquidity and yield of their securities' portfolios. Moreover, the virtual freezing of the banks' commercial loans did hurt their profit picture though this was ameliorated somewhat by the commissions derived through Victory Loan campaigns. In principle though, the Canadian state during wartime had gained access to an ongoing source of interim financing at very low rates. It is highly doubtful whether this operation could have been achieved without the apparatus of a central bank and the insistence of a Clifford Clark.

The foregoing suggests that the Bank of Canada too was capable of exercising considerable leverage over the investment policy of chartered banks *during wartime*. We have seen that the banks held approximately $1 billion in low-yielding deposit certificates. As late as 1948, the banks were still livid about holding these certificates. How can this *forced* holding of government bonds at very low interest rates be explained? The nature of the leverage applied may be characterized as *positional* and *political*. Bank officials wield positional power insofar as they are responsible for the regulation of credit and currency *in the national interest*. The Bank interprets the national interest and this responsibility may be used as a club by the central banker when confronting recalcitrant bankers. The Governor would attempt to reduce chartered bankers' arguments to parochial whining and appeal to their sense of patriotism or to an over-riding "public interest". The second aspect of positional power was the Bank's growing portfolio of government bonds. As early as 1941, the Bank was the largest single player in the market holding slightly more than ten per cent of the unmatured debt. This market power required that the chartered banks maintain cordial relations with the central bank for if a bank wished to sell off bills or bonds to write new loans, the central bank was an important buyer. Alienating the central bank and largest trader of Canada paper when one wished to unload some bonds was not "politic". Thirdly, the Bank's very close working relationship with Finance gave and still gives the Governor and his senior officials the

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[611] *Minutes of the Proceedings and Evidence of the House of Commons Standing Committee on Banking and Commerce*, 19th Parliament, 5th Session, No. 7, 23 May 1944, p. 203.

opportunity to offer advice on economic policy (taxation, expenditure) and on all–important amendments to the Bank Act.

Political leverage is the political, and to a lesser degree, bureaucratic equivalent of the investment community's power to interpret market trends. Whereas the investment counsellor reads tea leaves on which direction security prices are heading, it is the politician who testifies on the most vital political tendencies and on the legislative agenda. We have seen that both Clark and Sellar introduced various political arguments in their plea for lower interest rates. After the Bank of Canada was created, this bargaining was further buttressed by a growing market power which gave the bank the ability to make its own interest rate forecasts come true. Moreover, banking is federally regulated and thus when the Government holds a majority in the House of Commons, its interpretation of the "public will" has a considerable influence on the investment behaviour of banks. Banks therefore must be vigilant in avoiding the wrath of majority governments. This is not to say they are completely defenseless however. Finally, political leverage is demonstrably more effective during wartime or periods of political crisis. A climate of political uncertainty facilitates the introduction of measures which would otherwise have been impossible during normal times.

Table 6.3

Deposit Certificate Issues, 1942–1953

Due Date	Interest Rate (%)	Amount $Millions
April 6, 1943	.750	45
April 13, 1943	.750	90
August 17, 1943	.750	90
August 24, 1943	.750	90
August 31, 1943	.750	120
September 3, 1943	.750	90
September 14, 1943	.750	130
September 21, 1943	.750	110
September 28, 1943	.750	55
Outstanding March 31, 1943		820
April 4, 1944	.750	70
April 11, 1944	.750	100
April 18, 1944	.750	105
August 29, 1944	.750	57
September 5, 1944	.750	90
September 12, 1944	.750	129
September 19, 1944	.750	110
September 26, 1944	.750	130
Outstanding March 31, 1944		790
April 3, 1945	.750	130
April 10, 1945	.750	50
April 17, 1945	.750	140
April 24, 1945	.750	145
August 28, 1945	.750	57
September 4, 1945	.750	90
September 11, 1945	.750	129
September 18, 1945	.750	110
September 25, 1945	.750	150
Outstanding March 31, 1945		1,000
April 2, 1946	.750	95
April 9, 1946	.750	95
April 16, 1946	.750	95
April 23, 1946	.750	95
September 3, 1946	.625	75
September 10, 1946	.625	95
September 17, 1946	.625	95
September 24, 1946	.625	95
Outstanding March 31, 1946		740
April 1, 1947	.625	40
April 8, 1947	.625	40
April 15, 1947	.625	40
April 22, 1947	.625	40
September 9, 1947	.625	40
September 16, 1947	.625	40
September 23, 1947	.625	40
Outstanding March 31, 1947		280

Table 6.3 (contd)

Due Date	Interest Rate (%)	Amount $millions
September 3, 1948	.625	100
Outstanding March 31, 1948		100
September 2, 1949	.750	100
Outstanding March 31, 1949		--
August 29, 1950	.750	100
Outstanding March 31, 1950		100
August 29, 1951	1.000	200
Outstanding March 31, 1951		200
August 27, 1952	1.366	200
Outstanding March 31, 1952		200
May 15, 1953	1.75	200
Outstanding March 31, 1953		200

SOURCE: *Public Accounts of Canada*, (Ottawa: 1943–1953).

Commercial Lending: 1930-1952

The transformation of chartered bank–government relations from the pre–Bank of Canada era to the post–Bank era is most striking in the area of commercial lending. Prior to 1935, the banks were completely on their own and expanded and contracted credit as they saw fit. After the Bank's creation, the Governor terminated the "negotiations" on Dominion loans but did not obtrude into the banks' commercial lending activities at least, this appears to be the situation based on an examination of records at the various archives. This lack of intervention is suggested in the continued stagnation of commercial lending after 1935 despite the avowed reflationary efforts of the central bank. However, during and after the War, the Bank began to influence the lending activities of the chartered banks, transcending the former, hands–off, *laissez-faire* approach which typified government–bank relations for decades.

Prior to and during the 1928–29 orgy of speculation, several Canadian bankers railed against the excesses then taking place in stock markets.[612] With the massive contraction of commercial and agricultural credit which commenced in 1930, bankers then

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[612]For instance Statement of General Manager Peleg Howland, Imperial Bank of Canada, *Annual report, 1929,* p. 16 and Sir John Aird, President, Canadian Bank of Commerce, *Annual Report, 1929,* p. 36.

started to emphasize the fiduciary aspect of banking, their role in protecting the hypothetical widows' and orphan's funds on deposit. During the 1930s, bankers downplayed their equally critical role in supplying credit to industry and agriculture. Conservatism was the name of the game. In reponse to charges that the banks were not making credit available came the retort that there was insufficient demand for credit. In the view of one apologist, it was "improbable that there is a deserving and credit-worthy borrower who is being denied assistance" with "the strenuous competition for good loans presently existing among the banks."[613] Still, the question remained what was a "good loan", an "adequate risk"? The judgement of the agricultural borrower and the bank lender were definitely at odds over this question. While bankers stoutly maintained that they could only safely lend to credit-worthy customers what was on deposit, this myopic view failed to realize that the process of creating bank credits also created deposits in other banks.

In an effort to ameliorate the crisis, the Bank of Canada's monetary policy was designed primarily to arrest the vicious spiral of deflation and credit contraction through increasing the cash reserves of the banks. The results of the Bank's efforts were felt very slowly. Between 1936 and 1939, bank loans grew by 10 per cent to a level of only 55 per cent of the 1929 level. Hence, the main beneficiaries of this cheap money policy were not private debtors whose increased indebtedness was viewed as a *sine qua non* for recovery but governments at all levels which continued to run deficits. In general, the banks financed government deficits as Gibson maintained. In a depression the banks substituted gilt-edged government bonds in place of commercial investments- relief was financed instead of work.

During the war, the Dominion's heavy borrowing requirements, its dominance and control of capital markets limited the banks' commercial lending activities. In 1939-41, commercial lending surged ahead to underwrite the initial industrial expansion and then declined reflecting the state's decision to restrict the growth of bank lending and to monopolize the credit resources of Canada's banking system.

In the post-war period, the Bank of Canada began to influence commercial lending in several ways. In February 1948, the Bank publicly called on chartered banks to cease their financing of long-term capital projects which were more properly financed with

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[613]E. Scott Coffin, "The Chartered Banks as a factor in Canada's Welfare," *The Journal of the Canadian Bankers' Association*, Volume 46, No. 1 (October 1938), p. 55.

equity or debt capital issues.[614] Another attempt at influencing bank credit policies was witnessed in February 1951 when secret discussions resulted in an ad hoc agreement to limit credit expansion. This arrangement, to undertake a "more rigorous scrutiny of applications for credit with a view to curtailing advances for less essential purposes," followed a rise in the Bank Rate to 2 per cent in October 1950.[615] One other form of intervention into the banks' internal credit policies which could be justified by the *Bank of Canada Act's* preamble– "to regulate credit and currency in the national interest"– carried over into *private* criticism of *individual* bank lending policies. In December 1951, Towers believed that some banks were "overloaned" meaning that they had too much in the way of loans written to one major customer. The following January Towers urged the banks to issue more capital and stated that "I am not at all happy when I see cases where a bank may have as much as 20 per cent of its capital and reserves tied up in a loan to one borrower, particularly when that bank's capital and reserves may not be more than 5 per cent of its total loans and non-government investments."[616] This dialogue illustrates the development of the central bank from a quiet holder of government bonds in the early years with very little market influence to an active regulator. In a way, the fears expressed by a past generation of bankers were coming true– a semi-public, politically accountable agency was now mixing in the business of commercial banking.[617]

Summary

The principal findings of this chapter are summarized below.

1. The leverage exercised by the banks on the Dominion was based on their collective ownership of the biggest share of maturing debt and its effective internal coordination through the offices of the Canadian Bankers' Association. This share, often over 50 per cent of maturing obligations, gave the banks the opportunity to negotiate privately behind closed doors with the debtor over the term and yield. The

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[614] Bank of Canada, *Annual Report, 1948,* (Ottawa: 11 February 1949), p. 79.
[615] Bank of Canada, *Annual Report, 1951,* (Ottawa: 11 February 1952), p. 9.
[616] Towers Memoranda, No. 673, 23 January 1952, "Meeting with General Managers– Liquidity and Capital Ratios," *Bank of Canada Archives.* This comment seen in light of the most recent criticisms made of banks committing 25 to over 50 per cent of their capital and reserves to one borrower, i.e. Dome Petroleum, indicates the general deterioration in the quality of management and regulation of the Canadian banking system.
[617] For instance the warnings of Sir Charles Gordon, President, Bank of Montreal, *Annual Report, 1933,* p. 8 and Sir John Aird, President, Canadian Bank of Commerce, *Annual Report, 1934,* p. 29.

banks drive for yield and liquidity was most visible in the bankers' protests against the institution of the deposit cerificate. This non-market relationship tended to hamper the Government's attempts to fund the debt given the banks' own preference for short-term bonds particularly in the early part of the period.

2. Evidence surveyed does not show that state indebtedness to bank allowed the banks to determine specific economic policies. This structural relationship based on continued borrowing during the 1930s did allow banks ready access to the corridors of power. Bankers and Finance Department officials spoke the same language and made the same assumptions about the economy. Out of this shared world view were developed a set of unstated norms and expectations which guided policy-making. These assumptions included freedom and sanctity of contract, the supremacy of the market, a limited role for government, and the need to maintain business confidence. These assumptions were not shared to the same extent after the war.

3. The emergence of a central bank enabled the Dominion (Department of Finance) to eliminate the direct head-to-head negotiations previously observed. After 1935, terms were tailored by the Bank on the basis of informal market contacts and rates determined largely by secondary market trading and promulgated to the banks and other distributors by the Bank on behalf of the Government.

4. The transformation of the functions and responsibilities of the chartered banks and the Bank of Montreal specifically, did not undermine the unity of purpose shown by the state's core institutions (Finance, central bank) and the banks in resisting the Social Credit contagion. The advice requested of and given by state officials served to confirm, strengthen and protect the Dominion's powers in the fields of banking, currency, and credit.

5. During the initial phase of the Bank of Canada's operations, it met with only a limited success in persuading the commercial banks to increase their loans through the

expansion of the banking system's cash reserves. The extraordinary powers taken by the Dominion during World War II meant a controlled economy and capital market, manifest in stable bond prices, which remained firmly under the watchful control of Towers and Clark. This temporary subordination placed chartered bank resources at the command of the Dominion at or below cost of deposits. Chartered bank resistance was based on their requirements for liquidity and yield.

6. After the War, the central bank's actions extended into monitoring the lending of the chartered banks. Their lending policies were scrutinized and subjected to considerable criticism both privately and publicly. This degree of official criticism, mild when compared to the speeches of socialists and social crediters, is in sharp contrast to the silence observed during the Depression when the urgency of the situation was more immediate. By 1952, the former powers of Canadian banks had been severely eroded. The cosy cartel of branch banking in which general managers could determine credit policy was long past.

7. The Canadian Bankers' Association performed a critical role in organizing meetings with government officials and ministers. Moreover, it functioned as a conduit funneling information between general managers and from the banks to the Government. Equally crucial, the organization served as the nexus in resolving internal conflicts privately and maintaining a public image of unity and strength.

VII. INVESTMENT DEALERS

Dealers, unlike the banks, were more receptive to the creation of a central bank. Besides being a new player in the market, it was expected that the Bank of Canada would exert a steadying influence, smoothing price drops and rises. The Bank's desire to see a broader and deeper market in debt instruments seemed to guarantee the dealers some prospect for a larger role in the sale and distribution of government debt which eventually came about with the creation of a money market in the early 1950s. In this chapter, a brief description of the history and nature of investment dealing and the structure of the industry is provided. This sketch is provided to explain how the nature and structure of the industry determines the behaviour of the various firms. Since firms were and still are privately controlled (the main exception to-day being Midland Doherty), there is virtually no historical information whatever on individual firms' revenues, expenses, assets, and liabilities. Furthermore, the Investment Dealers Association of Canada and its immediate predecessor, the Investment Bankers Association, did not, until quite recently, maintain satisfactory records of its activities.[618] The I.D.A., like the generally secretive Canadian Bankers' Association, has never sanctioned nor been subject to an official or unofficial studies except those brief sketches published in Royal Commission reports.[619] The remaining sections explore the industry's drive for remunerative commissions, new bond issues, the allotment of securities, and lastly, the territorial conflict that has characterized relations between the banks and the investment dealers.

Nature of Investment Dealing

History

As early as 1832, a group of Montreal brokers met to transact business and a decade later formalized these meetings to become the Board of Stock and Produce Brokers. In 1852, a stock exchange was established in Toronto which was a far cry from the complex,computerized and regulated market of to-day. In 1872, the Montreal Stock Exchange opened for business with listings dominated by railways, insurance company and bank stocks, and government debentures.

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[618] Ronald S. Ritchie, Senior Policy Advisor, Investment Dealers Association of Canada to author, 23 April 1982.

[619] Royal Commission on Banking and Currency, *Report*, p. 27; Royal Commission on Banking and Finance, *Report*, Chapter 16.

The *British North America Act*, drafted at a time in which bond trading was of minor importance, does not specifically enunciate under what jurisdiction the operations of bond houses and capital markets fall. Strangely enough, there have not been any major disputes over the constitutionality of provincial regulation of the securities market and stock exchanges, unlike life insurance, for instance.[620] The most compelling reason for leaving the provincial governments to regulate firms and markets is perhaps the primarily local services provided by the bond houses. . Aside from Charles Dunning's 1938 threat (discussed below) to regulate the industry under the "trade and commerce" power if the industry did not act to regulate itself satisfactorily, the industry has remained largely self-regulating under provincial supervision.[621]

The formal creation of bond houses engaged in underwriting and distributing securities may be said to have commenced by the 1880s with dealings primarily in high-grade provincial, municipal and Dominion bonds. The major firms were extremely small compared to their foreign counterparts owing to the fact that the majority of bond placements originated in London and secondarily New York.[622] In fact, in the beginning these firms often acted as adjuncts to London based dealers in the tendering on domestic issues and filling clients demands for United Kingdom securities. The earliest firms to be engaged primarily in bond trading were Hanson Brothers (1883), A.E. Ames (1889), Dominion Securities (1901), and Wood, Gundy and Company(1905).[623]

An investment dealer buys and sells securities either as an *agent*, for clients, or as a *principal*, for the firm. Another word for the agency function is the "brokerage" function. A principal may be referred to as a "jobber", who according to E.P. Neufeld, takes "a position in securities that are being traded, reduces short-term price fluctuations in that way and thereby improves the functioning of the market, an improvement based on his superior knowledge of market values." [624] Investment dealers, known as "investment

[620] See Christopher Armstrong, "Federalism and Government Regulation: The Case of the Canadian Insurance Industry". *Canadian Public Administration*, Volume 19, no. 1 (Spring 1976), pp. 88-101.
[621] Towers Memoranda, No. 136, 13 May 1938, "Conversation with Dunning, Clark and Henderson re. Pringle's letter...", *Bank of Canada Archives*
[622]For example, in 1905 the Dominion's debt payable in London was $209 million whereas only $7.4 million was payable in Canada.
[623] See Neufeld, 1972, pp. 459-489. See also Jorge Niosi's account of the development of five of the major Canadian "investment banks" in *The Economy of Canada: Who Controls It?* Trans. Penelope Williams, (Montreal: 1978), pp. 47-62.
[624]*Ibid*, p. 25. After the central bank was set up, it acted as the sole jobber in Canada bonds.

bankers" before the 1934 *Bank Act* revision, earn their livelihood from (1) *commissions* on the sale and purchase of debt capital (bonds, debentures) and equity capital (common and preferred shares), (2) *capital gains* on inventory dispositions, and (3) *underwriting* new stock and bond issues.

Underwriting, which is central to any major investment house, involves the formation of an underwriting syndicate whose task is to bid on bonds (tender) as was done in the 1930s for municipal and provincial bonds at a set price or make an offer to an issuer to buy the bonds at a *negotiated* as opposed to tendered price, and undertake the distribution of the bonds to clients. The syndicate or underwriting group would require the financial assistance of a bank to line up the funds to advance to the borrower after their tender was accepted, but before they sold the bonds to their clients, usually wealthy individuals or institutional investors. Prices were normally established at the last possible moment before "coming to market" as a safeguard against a sharp break in the market. [625] As so much of a firm's revenues derived from the new issuance of bonds, a sudden drop in prices would leave the dealer high and dry. As one dealer put it "the money (is) made in underwriting (the) last million." [626] When a dealer is stuck with the bonds, they usually must take them into a "long position " or inventory for to unload the bonds immediately would usually drive prices down. Being left with the bonds often meant paying substantial interest charges to the bank which arranged the initial financing.

Profitability was affected by the volume of new issues and conversion offers, the amount of secondary trading, the spread between the prices paid and that received for the bonds from the investor. Dealers were constantly on the watch in their position as fiscal agent or advisor to a municipality or province to recommend the best date to come to market. It was in the interest of the dealer to encourage borrowing because new issues produced underwriting profits and commissions for secondary market trading. In short, a larger volume of indebtedness was money in the bank for the dealers. Another parameter affecting profitability was the *allotment* received under a syndicate agreement. If the dealer received fewer bonds than it was committed to sell, it would then be forced to

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[625]See Testimony of W.C. Pitfield, President, Investment Bankers' Association, *Proceedings*, Royal Commission on Banking and Currency, 11 September 1933, pp. 3094-3095. *Interview*, 26 May 1982.

[626]Testimony of Mr. Milner, *Proceedings*, Royal Commission on Banking and Finance, 11 July 1962, Volume 26, p. 2670.

purchase the bonds on the open market, often at a premium to fill the order. The reality of rising bond prices in the "after-market" provided an inducement for dealers to "pad" their orders to assure themselves that they would receive sufficient bonds to meet clients' needs. The Bank of Canada acted to curb this tendency soon after it was created.

Underwriting fees are and were an important revenue source to investment firms. In the 1930s the industry was in very poor shape because of the virtual extinction of new corporate bond and stock issues.[627] Table 7.1 shows that the market for new corporate issues had dried up dramatically after 1930 and throughout the decade government business became the dealers' bread and butter. The stock market collapse caused a severe erosion of the earnings and the capital base of most firms by reducing the value of the underlying stock traded which served as the basis for calculating commissions. As a firm's capital base was the basis for borrowing, dealers became more reliant on their bankers during the Depression which sparked disputes between these financial groups.[628] As a result, to minimize the risk in underwriting new bond issues, dealers formed in 1932 a central co-operative of dealers which would handle the more risky, western issues.[629]

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[627]Investment Bankers Association, "Brief No. 2," *Proceedings*, Royal Commission on Banking and Finance, p. 3113.
[628] *Interview*, 26 May 1982, 1 June 1982.
[629] *Interview*, 26 May 1982.

TABLE 7.1

Sales of Canadian Bonds: 1928-1952

YEAR	Dominion	Provincial	Municipal	Railway	Corporate	TOTAL	TOTAL in Canada
1928	--	93.0	27.1	48.4	285.1	453.6	278.1
1929	--	120.0	98.7	199.2	243.3	661.2	378.4
1930	140.0	160.0	109.6	137.2	220.3	767.2	368.9
1931	858.1	126.2	85.3	121.8	59.4	1,250.8	1,090.8
1932	226.3	128.2	95.6	12.6	10.6	473.1	377.6
1933	440.0	82.9	41.3	1.0	4.4	569.6	434.6
1934	400.0	139.9	24.7	32.5	40.9	638.0	529.6
1935	739.3	123.4	44.8	48.4	60.6	1,016.5	853.9
1936	793.0	118.7	34.4	133.0	220.0	1,299.4	1,194.8
1937	919.0	174.4	52.1	30.4	89.6	1,265.4	1,177.2
1938	903.5	118.8	35.2	19.5	56.0	1,132.9	1,044.0
1939	1,024.6	154.1	26.9	6.5	236.2	1,448.3	1,316.7
1940	2,079.9	156.8	25.2	--	25.1	2,287.1	2,300.1
1941	1,996.8	69.7	13.5	--	16.1	2,098.1	2,087.3
1942	4,156.1	96.9	23.6	--	14.0	4,290.5	4,274.7
1943	3,670.0	97.6	14.2	--	53.1	3,855.4	3,729.3
1944	3,401.0	67.1	113.2	--	92.1	3,684.0	3,629.0
1945	3,577.7	162.0	30.4	--	153.9	3,935.0	3,855.0
1946	985.3	114.3	140.8	--	581.5	1,865.1	1,801.4
1947	293.3	229.6	238.9	--	379.7	1,156.4	1,068.1
1948	445.5	312.6	84.0	--	310.5	1,173.6	1,023.6
1949	790.2	449.3	134.8	--	285.3	1,683.5	1,543.5
1950	2,167.6	373.8	150.4	--	431.2	3,153.4	2,980.7
1951	594.6	369.5	196.4	--	451.6	1,650.2	1,233.7
1952	787.8	427.0	147.7	--	573.5	1,985.2	1,700.6

(in millions $Canadian)

SOURCES:*Canada Year Book*, various years.
Includes both Cash and Conversion Sales

Industry Structure

The structure of the investment business was, and remains quite decentralized in comparison with Canada's concentrated banking system. The investment industry is not monolithic being comprised of many small firms specializing in certain types of equities or municipal, provincial or corporate bonds. The larger, more established firms such as Wood, Gundy and A.E. Ames were "integrated" with research, government finance, corporate finance, and securities trading departments. Over the last fifty years, the typical firm has grown from a "one-man, one-wire" operation to a multi-faceted, multi-branch organization owned by dozens of partners. The capital base of large firms to-day are in

the tens of millions with assets in the hundreds of millions.

Although preliminary discussions took place in 1911, the Bond Dealers' Association of Canada was not formally established until 1916. It began as a voluntary organization with 32 members. The rapid growth of the business during the First World War meant that by 1919, 72 members belonged to this voluntary association. By 1933, the Investment Bankers Association could claim a membership of 101 members. In 1958, membership in the Investment Dealers Association peaked at 206. By 1981 however membership had declined to 78. In recent years the industry has undergone dramatic changes with the merger of Dominion Securities and A.E. Ames in 1981 and Greenshields and Richardsons in 1982, to name only the major recent mergers.

Commissions

Commissions are based on the spread between the purchase price from the borrower and the ultimate price recieved by the dealer from institutions and the public. The size of commissions was also related to the volume of the issue, Dominion issues being in the tens of millions while provincial and municipal issues usually came in below ten million. An indication of the importance which dealers placed on the commission cheque from Dominion of Canada issues and the relatively short-time perspective of the dealers comes from the following letter from an investment dealer to W.C. Clark in 1940.

> I can readily understand that you would get fewer kicks from dealers on this loan, for the very good reason that, for the present at least, you have them by the short hairs – i.e., they are waiting for a cheque from you in respect to their share of the pooled commissions on the exempt list. There were lots of kicks– some of them legitimate; most of them otherwise. As I see it, far too few of the fellows who are prone to complain, desire, or for that matter have the ability, to look beyond their nose.[630]

The first major discussion about refinancing and commissions in this period took place between J.H. Gundy (representing a syndicate comprised of A.E. Ames, Wood Gundy, Dominion Securities, the Bank of Montreal, the Commerce and the Royal Bank) and Charles Dunning in March 1930. Gundy in a lengthy memorandum (referred to in Chapter V) was anxious to take advantage of the Dominion's desire to advance refund the huge volume of maturing issues at a time of relatively low interest rates. This proposal was

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[630]F.W. Kerr to W.C. Clark, 24 January 1940, *Public Archives of Canada*, RG 19, File 155-75.

made at a time of severe strain on the dealers who sought an operation which promised both success and large volumes and thereby handsome commissions. The proposal ultimately put foward to Acting Deputy Minister of Finance, Watson Sellar and Prime Minister R.B. Bennett called for a spread of $1.75 for cash sales ("new money") and $1.35 for conversion sales.[631]This was rejected by the Minister on recommendation of his officials as being too costly for a *refunding* operation. In an interesting "counter-proposal" put forward by a group of smaller dealers, it was suggested that the Dominion pay advertising costs, that banks receive a negotiated commission, and dealers receive a 1/2 per cent commission and sub-agents, 1/4 per cent. [632] This proposal was not taken up although the suggestion that the Dominion assume the advertising costs was adopted for the Conversion Loan of May 1931 and subsequently became standard operating procedure.[633]

Like banks who operate on a loan "spread", dealers are interested in achieving a large differential between the "purchase price" from the borrower and the "sales price" to sub-agents, institutions and the general public. This spread was the *incentive* deemed necessary to induce dealers to sell to a wider clientele. In correspondence and meetings with Bank officials, members of the Investment Dealers Association consistently stressed the need for higher commissions "to stimulate sales" and to provide the organization for a wider distribution of bonds– a policy espoused by the central bank. [634]

The necessity of providing the investment community with a financial incentive was foremost in the minds of the Working Committee established in September 1939 by the Government to recommend a war financing policy. Composed of bankers and dealers, the report stressed the importance of ensuring that the first issue be an "outstanding success." [635]

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[631] Memorandum B.J. Roberts to Watson Sellar, "New Issue and Conversion," 12 October 1930, and Sellar to Ryckman, 13 October 1930, *Public Archives of Canada*, RG 19, RG 19, Volume 592, File,155–30.

[632]Letter to Minister of Finance from Fry, Mills, Spence & Co., Bell Gouinlock & Co., Ltd., and McLeod Young Weir & Co., Ltd. 15 October 1930, *Public Archives of Canada*, RG 19, RG 19, Volume 592, File 155–30.

[633]This of course did not prevent the dealers from separately advertising the loan for potential buyers.

[634]J.E. Savard, President, Investment Dealers Association to K.A. Henderson, 21 May 1936, *Bank of Canada Archives*, DG 400– "Dominion Government Financing 1935–38," and "Meeting with Representatives of the Investment Dealers Association at Bank of Canada," 29 November 1938, DG 400 "Dominion Government Financing 1935–38," *Bank of Canada Archives*.

[635]*Report of the Working Committee, Dominion of Canada Financing*, 24 November

In recommending a *competitive* rather than *co-operative* mode of marketing, the Working Committee advocated the setting of a *satisfactory commission* "to provide for the organization and selling costs involved in a nation-wide sales effort, and to assure that these bond selling organizations shall be available for the larger and more difficult operations which are to be expected." [636] There can be little doubt that by 1939 the dealers were restless in waiting for the heralded economic recovery and desperately needed a financial shot in the arm. This is implicit in the following letter from D.I. McLeod to Clark in which McLeod argued that the Government had a direct stake in maintaining the dealers' organization intact.

> I do not think that the Canadian investment dealers desire to think at all in terms of profit at a time like this. On the other hand, for their own preservation, I do not think that they can keep intact for a very long period their machinery for the intensive distribution of securities unless they know fairly definitely that the services of their organizations will be required by the Department of Finance at not too remote a date in the future.[637]

From the Government's perspective, commissions represented an off-the-top, one-time only charge for placing the bonds. A high commission would be an inducement to sell as many bonds as possible but Towers saw too large an incentive to have marginally diminishing returns. When discussing the 1937 Refunding Loan of $100 million, Clark proposed an additional .25 per cent underwriting commission on top of a .75 per cent sales commission. Towers representing the *de facto* underwriter rejected this disguised commission, adding the extra commission "would not add greatly to the Dominion's reputation for seriousness and plain dealing in matters of finance." [638]

Allotments

Padding

With respect to the issue of allotments, dealers were anxious to purchase a sufficient quantity of bonds to meet clients' demands and for inventory purposes, often to

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[635](cont'd) 1939, p. 9, *Public Archives of Canada*, RG 19, RG 19, Volume 604, File 155-75.
[636]Working Committee, p. 14.
[637]2 October 1939, *Bank of Canada Archives*, DG8-2 "The Deputy Minister of Finance, 1935-1944."
[638]Towers Memoranda, No. 75, 29 October 1937, "Conversation with Charles Dunning," *Bank of Canada Archives*. It is informative to note that criticisms about the level of remuneration were directed at the oligopolistic banks and not towards the rabidly competitive dealers. After the Bank's creation, commissions were set by the Bank on behalf of the Government. The commission was based on whether new cash was received (higher rate) and the term (longer term, higher rate).

turn a profit when the issue traded at an early premium. One of the first tasks of the new central bank was to devise a set of procedures for the marketing of public debt. The elimination of "padding" was a major concern of the Bank's. This practice saw "salesmen of larger houses telephone to stockbrokerage friends asking them to put in an order.......such orders immediately assume that the loan is to be a big successand put in some orders of their own."[639] Often the names entered on the subscription lists were fictitious, a practice which was difficult, if not impossible, to detect. As Towers remarked in a letter to Charles Dunning, "padding takes on a ridiculous scale, with the result that the more daring padders get a disproportionate amount of the bonds and the orderly marketing of the issue to investors is thereby prejudiced."[640] Padding guaranteed that the padders would secure sufficient bonds to be able to meet customers' demands and more, which enabled the firm to sell bonds into a rising after market to turn a quick profit. To prevent this practice, the Governor was prepared to *sell* bonds into a runaway after-market to curb this form of unhealthy speculation. [641]

The real impetus to change these speculative practices began in early 1938. In a memo prepared by the General Manager of the Bank of Montreal, the pernicious effects of a "flood of subscriptions from small dealers for amounts which the inexperienced eye could identify at once as being far beyond the capacity of these bond houses to take care of," was sketched. [642] As a result of this complaint, discussions were held with the Investment Dealers Association. The Association pressed for the *exclusion* of non-I.D.A. members, the creation of an "exempted list" to prevent dozens of dealers from courting the same institutional investors with a commission to be pro-rated among I.D.A. members, a 1.25 per cent commission to I.D.A. members and 0.5 per cent to sub-agents.[643] The history of the pooled commission concept may be traced to Spence, Mills et al

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[639] See "Memorandum on Dominion Government Loans," 25 May 1938 and "Memorandum of Discussions," 13 June 1938, *Bank of Canada Archives*, DG 400- Dominion Government Financing- 1938-1939. (Presumably authored by the Securities Advisor, K.A. Henderson)

[640]Towers to Dunning, 20 December 1938, *Public Archives of Canada*, RG 19, Volume 589, File 155-0-97.

[641]See "Memorandum of Discussion," 25 May 1938, *Bank of Canada Archives*, "DG-40 Dominion Government Financing, 1935-39."

[642]Jackson Dodds Memoranda, "Dominion Government Loan," 26 May 1938, *Bank of Canada Archives*, DG 400- Dominion Government Financing 1935-39.

[643] K.A. Henderson to Dr. Clark, "Memo re. suggestions received regarding Offering of Dominion issues by Bank of Canada," 22 December 1938, *Public Archives of Canada*, RG 19, RG 19, Volume 589, File 155-0-97.

counter-proposal to the Gundy syndicate in October 1930. Spence, Mills and their associates recommended the pooling of commissions for financial institutions (trust and insurance companies) when converting government stock. This suggestion for an exempt list of institutions would have eliminated dealer line-ups outside treasurers' offices seeking to arrange the proposed conversion.[644] This suggestion had been put forward, this time by the I.D.A. President, J.E. Savard in May 1936 to bank officials.[645] This type of request conforms closely to the model of interest group behaviour advanced by Kwavnick in his study on the Canadian Labour Congress.[646] The I.D.A. desperately wanted *official recognition* as the sole distributing group for Dominion issues along with the ubiquitous banks. The group also sought a type of *controlled competition* for its members through the mechanism of an exempted list, eventually implemented during the War. There were some in the Bank, including the Governor, who felt that stockbrokers should be removed from the list thus strengthening the role of the I.D.A..[647] However, in the minds of Bank officials and Dunning, the Association had to "clean up its act" before being granted this virtual monopoly. Dunning was fully prepared to regulate against the abuses of the 1926-1929 period under the trade and commerce clause if the dealers were unwilling to institute a satisfactory form of self-regulation.[648]

Ultimately a decision was reached by which the Bank offered bonds "firm" to an approved list of distributors, including stockbrokers, with a five per cent deposit required to discourage unnecessary and speculative padding. In addition, the Bank instituted a rule preventing the sales of bonds below issue price until the bank lifted the restriction. This restriction was usually lifted after the delivery of bonds. The dealers were eventually able to get around this trade restriction by "over-trading" or entering into swap arrangements with customers. This allowed the dealer to sell the bond at issue price but in return the

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[644] Letter to Minister of Finance from Fry, Mills, Spence & Co., Bell Gouinlock & Co., Ltd., and McLeod Young Weir & Co., Ltd. 15 October 1930, *Public Archives of Canada*, RG 19, Volume 592, File 155-30.
[645] J.E. Savard to K.A. Henderson, 21 May 1936, *Bank of Canada Archives*, DG 400-"Dominion Government Government Finance, 1935-38," *Bank of Canada Archives*.
[646] *Organized Labour and Pressure Politics*, (Montreal and London, 1972),
[647] "Memorandum of Discussion," *Bank of Canada Archives*, DG-400 Dominion Government Financing, 1935-38.
[648] Towers Memoranda, No. 136, "Conversation with Dunning, Clark and Henderson re. Pringle's letter...", 13 May 1938, *Bank of Canada Archives* and K.A. Henderson to Dr. Clark, "Memorandum re. suggestions received regarding offering of Dominion issues by Bank of Canada," 22 December 1938, *Public Archives of Canada*, RG 19, Volume 589, File 155-0-97.

dealer received a bond which was priced below its market value.[649] It was also decided that firm allotments would be based primarily on the placing record of the various firms– past performance would determine present allotments.

The importance to a firm of allotments is reflected in correspondence between dealers and the Government concerning the Dominion's domestic and foreign placements. In February 1936, Mr. Weldon of Midland Securities petitioned Clark to have his firm's allotment increased. The Deputy did acknowledge that he had called "attention to the fact that the amount which it was proposed to allot to your firm did not, in my opinion, represent its placing power, and I suggested that the amount should be increased."[650] Weldon in turn requested further assistance from Clark who replied that he had done all that he possibly could do to bring this to the attention of the authorities at the Bank of Canada.

Canadian dealers hoped to use their nationality to receive favoured treatment from lead underwriter, Morgan Stanley in U.S. transactions. In 1938, Clark received several supplications from R.W. Gouinlock of Bell, Gouinlock and W.C. Pitfield of Pitfield and Company to have Morgan Stanley give a fair and sympathetic consideration to Canadian houses in general.[651] In reply to Gouinlock, Clark stated:

> Frankly, I do not see that we can be the judge in these matters. Our bankers, Morgan Stanley & Co., are responsible for the success of any issues they underwrite and they must give us a guarantee of performance of their underwriting associates. We feel that we cannot insist on such a guarantee if we are to interfere in the selection of their associates.[652]

Gouinlock, not entirely satisfied with this explanation, reiterated the expectation "that we have a right to ask our own Government, when they are arranging a loan of this character, *to have us taken care of in the purchase group* in view of our past record in the field of Government and Provincial financing."[653] Blood however was not thicker than water in these matters. The Deputy Minister had to manage these applications diplomatically as

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[649] Bank of Canada, *Submission by the Bank of Canada to the Royal Commission on Banking and Finance*, (Ottawa: May 31, 1962), pp. 50–51.
[650]Clark to Weldon, 15 February 1936, *Public Archives of Canada*, RG 19, Voume 592, File 155–30, Volume 3.
[651]R.W. Gouinlock to W.C. Clark, 28 October 1938, W.C. Pitfield to W.C. Clark, 2 November 1938, *Public Archives of Canada*, RG 19, Volume 604, File 155–71–2.
[652]W.C. Clark to R.W. Gouinlock, 3 November 1938, *Public Archives of Canada*, RG 19, Volume 604, File 155–71–2
[653] R.W. Gouinlock to W.C. Clark, 8 November 1938, *Public Archives of Canada*, RG 19, Volume 604, File 155–71–2. (emphasis added)

advocating "jobs for the boys" would have a damaging effect on the Dominion's all-important "reputation" on Wall Street. The Dominion, in pressing these special claims on the venerable investment bank, which was well paid for its work, advice, and distribution capacity, would likely have found this special pleading to be counter-productive.

After the war, the large Canadian dealer, Wood, Gundy sought a position in lead underwriting alongside Morgan Stanley. Morgan Stanley's Perry Hall felt that Wood Gundy should not have any priority position or special claim for a joint account by virtue of the fact that it had a firm order for $50 million in bonds. Towers, present at this exchange, declined to express any opinion for this was a governmental *viz.* a political decision. Morgan Stanley remains the Dominion's lead underwriter to the present while Wood Gundy, Solomon Brothers, and Dominion Securities Ames co-manage the underwriting under Morgan Stanley.

Relations with Banks

Competition from the banks in the bond distribution business was a longstanding complaint of the dealers. This conflict originates in the distinct nature of the two types of businesses. Dealers were responsible for distributing new debt and equity issues which had the practical effect of removing funds from the banking system and converting these moneys into instruments which could be freely traded in the secondary market. Banks,on the other hand, were principals primarily concerned with earnings and not commissions. Another dimension to the conflict was that the banks' maturity preference was short term whereas the dealers were responsible for mobilizing funds for a long-term (debt) or an indefinite period of time (equity).

After the Conversion Loan of May 1931, the Investment Bankers Association approached the Canadian Bankers' Association to inquire about press reports that banks handled the distribution of these securities. The Canadian Bankers' Association did acknowledge that some bank managers may have been over-zealous taking business away from the dealers, yet the Association claimed it was not in a position to bring the thousands of branch managers into line. This was certainly a specious explanation given the strict hierarchical structure of the major chartered banks. The banks also maintained

their usual argument that they performed an essential role in distributing securities to persons in remote areas where no brokers or dealers were situated.

The extent of this keen competition may be ascertained from the following letter written by an Ottawa-based dealer to the Securities Advisor. "The worst and most destructive competitor we have," wrote the dealer, "is the manager of the Ottawa office of the "B. of M." which I think should be "ticked off"."[654] The territorial rivalry also related to the financing of underwriting. In their "Brief No. 2- Banks Engaging in the Bond Business" presented to the Macmillan Royal Commission, it was claimed:

> The presence of of banks in underwriting syndicates has on numerous occasions created situations where the security dealer is deprived of the confidential relationship which he shall have with the commercial bank which he does his banking. At the present time when bidding or negotiating for new issues dealers often find it impossible to consult with their bankers in order to arrange loan accommodation and foreign exchange coverage and other details because the bank is likely to be a member of an opposing syndicate and it is of course out of the question for the dealer to disclose his plans to a competitor.[655]

The investment bankers also called for legislation which would limit banks to the "receiving of subscriptions or receiving of instructions for the client."[656] It was the general view of the dealers that it was in the public interest that the industry be protected lest the banks take over this important intermediary function.

During the War, sporadic complaints surfaced from dealers about bankers communicating with private purchasers to place their subscriptions through their bank branch. The banks were warned by the Chairman of the Executive Committee of the National War Finance Committee, a banker, that the banks could only offer to "service" subscriptions and must not prevent the bondmen from making the actual sale. Eventually the bondmen's lobbying paid of with amendments to the 1944 Bank Act revision which prevented chartered banks from placing their names on prospectuses with the exception of Government of Canada prospectuses.

In recent months, this long-standing, territorial dispute over jurisdiction has again become public. In June and July 1983 the Ontario Securities Commission held hearings on

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[654] 15 December 1938, DG 400 Dominion Government Financing 1938", *Bank of Canada Archives.*
[655] *Proceedings,* Royal Commission on Banking and Currency, p. 3114.
[656] Testimony of W.C. Pitfield, I.B.A.C President, *Proceedings*, Royal Commission on Banking and Currency, Toronto, September 1933, p. 3106.

the Toronto–Dominion Bank's proposed "Green Line Investor Service".[657] The Toronto–Dominion Bank argued that it is not infringing on the dealers' territory because these proposed services are 'unsolicited trades' which will executed by a broker. The Canadian Bankers' Association, in its submission, questioned the Ontario Securities Commission's jurisdictional competence to supervise the chartered banks' securities handling functions sanctioned under the federal *Bank Act*.

The joint industry committee, consisting of the four major stock exchanges and the I.D.A. has countered by saying the Green–Line service is soliciting trade.[658] The I.D.A. has also been quick to champion the traditional separation of the "four pillars" of financial intermediation: securities, banking, trusts, and insurance, while the banks have emphasized the gradual blurring of services in the financial sector. The present squabble is but another installment in a continuing war to protect and enlarge one' own jurisdictional territory. The origins of the battle are found in the ongoing tension between a loosely organized association of dealers with small offices scattered across the country, regulated by various provincial laws and a highly concentrated, federally regulated, banking bureaucracy.

It is worth noting that several smaller brokers have been called as witnesses by the chartered banks to testify against their industry's joint position showing that unanimity in the business is hard to achieve.[659] In addition, another clash occurred between two of the larger dealers, McLeod Young Weir who believes that one of its competitors, Burns Fry, by supporting the banks' position is attempting to steal away the lucrative lead underwriting spot for The Toronto–Dominion Bank.[660] The present conflict once again demonstrates the dealers' proclivity for internecine warfare based on short–term monetary gain versus the bankers' ability to present a unified position and to hide behind federal authority whenever convenient.

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[657]See Eric Evans, "Brokers vs. banks on 'public interest'," *The Financial Post*, 25 June 1983, p. 4.
[658]*Ibid*
[659]Richard Pivnick, "Broker feels reduced rates main objection to T–D plan," *The Globe and Mail*, Friday, 8 July 1983. It may also be noted that the traditional argument that this service is offered to those in remote, rural areas is now defunct. Only 30 per cent of the Toronto–Dominion Bank's securities business is conducted through its rural branches. (Evans, 1983).
[660] Eric Evans, "Hurdles in way of banks' entry to discount brokerage," *The Financial Post*, 2 July 1983, p. 4.

Summary

Based on this brief sketch of the Canadian investment industry, adequate commissions, large allotments, new cash and conversion issues were identified as the main grist for the dealers' mills. In attempting to improve profits, the dealers jealously guarded their underwriting position which gave them authority to allot the bonds, while at the same time fighting to gain entry into other underwriting syndicates. Dealers, did tend to unite in their contention that only satisfactory commissions could guarantee the success demanded by the issuer. We have also described how this loosely consolidated group of private individuals and firms was unable to demand a near monopoly on the distribution of Dominion securities because the Government perceived the I.D.A. as ineffective in bringing all its members into line. This perception was reinforced by the padding practices which continued after the Bank's formation. Tension between the central bank and the dealers was based on the former's desire to stem the sometimes speculative impulses of dealers and stock brokers whose antics had a damaging effect on the public's perception of the bond market as a place to gamble.

The I.D.A.'s quest to consolidate its organizational authority and to control competition i.e. persistent demands for an exempt list, is congruent with much of the literature on interest groups. Another related feature of interest group behaviour is the search for statutory recognition which has eluded the I.D.A./I.B.A.. While the industry, notably the bond trading segment, is largely self-regulating or regulated by the provinces, the protection of the industry still remains very much in the hands of federal legislators revising the *Bank Act* every ten years. This is because Parliament's regulation of banking enables Ottawa to extend or limit the scope of banking in a rapidly changing financial services marketplace. This battle over jurisdiction will remain a central preoccupation for dealers and banks and may result in some constitutional jurisprudence in the near future.

From the perspective of the issuer, the most important facet of the dealers' function was its distributional capacity. The issuer and central bank sought to encourage dealers to take on the role of jobber in the market, to hold bonds in inventory and to be a ready supplier to the market, and thereby act to stabilize bond trading. This objective was actively pursued after the war and resulted in the establishment of a dozen dealers being set up as jobbers in short-term government paper in 1953.

VIII. INTERNATIONAL BORROWING

> Canada must therefore have particular regard for the effect of its policies upon the confidence of foreign investors. Nervousness there would quickly manifest itself in the domestic investment market in a damaging rise in interest rates.
>
> Graham Ford Towers[661]

This chapter is organized into four sections: the first section provides a brief historical overview of Canada's international indebtedness from the pre–Confederation era through to the post–war period. The succeeding sections explore the *market conditions* affecting the *timing* of borrowing in London and New York; the effects of the *Alberta and Western situation* on the Dominion's credit standing; and the factors affecting the bargaining which went on with respect to the *after tax yield* received by the international creditor. Our objective is to assess whether in fact Canada's sovereignty was subordinated to the requirements of international finance capital. One of the deficiencies of the following analysis is the exclusive reliance on data from domestic sources. A more complete picture would be painted by examining newspaper and journal articles on Canada's credit from foreign sources.

Overview

In his essay, "The Penetrative Powers of the Price System," Harold Innis noted "The problem of the debt is the problem of Canadian federalism, as the federal structure is a credit instrument."[662] Students of Canadian political economy are all familar with Canada's dependence upon British portfolio capital which loaned billions to Canadian governments and syndicates mainly to finance railroad and canal construction. Often, private borrowings were guaranteed by provincial governments leaving them seriously exposed when the inevitable downturn brought these guarantees, either implicit or explicit, to light. The extent of this indebtedness to the London banking house, Baring Brothers, was possibly a factor contributing to the Confederation pact which consolidated most provincial indebtedness under a new, federal roof.[663]

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[661]Towers Memoranda, No. 236, 13 March 1939, "Submission to Rowell Sirois Commission," *Bank of Canada Archives*.
[662]*Essays in Canadian Economic History*, Mary Q. Innis, (ed.), (Toronto: 1973), p. 265.
[663]"The Barings and the Glyns were financial agents to the governments of New Brunswick and Nova Scotia as well, though with so much of their resources tied up in Canada they could do relatively little to provide funds for the other provinces. Nonetheless, some debts did exist. In fact, debts to the Barings were about the only thing the British North

This foreign indebtedness grew during the boom period, 1896 to 1910. During the Great War, the Canadian Government was compelled, for the first time, to depend on Canada's ill–developed capital market to raise the billions required for Canada's contribution to the war. Table 8.1 illustrates the phenomenal growth of the Dominion's domestically issued debt which stood at only $700,000 in 1914 but which then mushroomed to $880 million in 1918 and levelled off at $2 billion in 1920. Towards the end of the Great War, the first attempts were made at tapping funds in New York. The portion of Dominion debt payable in sterling dropped from 98 per cent in 1914 to 13 per cent by 1920 (excluding the Canadian Northern Railway's debt assumed in 1919), a rather astounding reversal.

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[663](cont'd)American colonies had in common before Confederation." R.T. Naylor, *The History of Canadian Business, Volume I, The Banks and Finance Capital*, (Toronto: 1975), p. 26.

TABLE 8.1

Distribution of Debt by Currency of Payment, 1900-1952.

Year (1)	Canada (2)	United States (3)	Payable in N.Y. (4)	U.K. (5)	Payable in London (6)	Two-Pay ** (7)
1900	3.7	--	--	96.3	228.0	
1905	3.5	--	--	96.5	209.5	
1910	1.8	--	--	98.2	257.5	
1912	1.7	--	--	98.3	282.0	
1914	0.2	--	--	99.8	302.8	
1916	21.7	--	--	78.3	362.8	
1918	66.8	5.8	75.9	36.4	362.9	
1920	81.4	5.4	135.9	13.2	336.0	-
1922	82.7	4.6	110.9	12.7	307.6	
1924	78.7	8.8	210.9	12.5	301.8	
1926	77.7	11.3	280.9	11.0	271.0	
1928	79.2	9.6	225.9	11.2	246.2	
1930	81.0	7.5	165.9	11.5	257.2	
1931	77.6	11.5	265.9	10.9	253.5	
1932	80.4	9.6	240.9	10.0	249.7	
1933	76.0	11.3	300.0	9.3	246.0	3.6
1934	72.9	10.5	300.0	13.5	315.3	3.1
1935	75.4	9.7	292.7	11.8	355.3	3.0
1936	73.6	11.1	366.1	12.6	351.7	2.7
1937	74.3	13.5	449.0	12.2	348.1	
1938	74.1	13.5	449.0	12.4	344.2	
1939	74.2	13.8	469.0	12.0	406.2	
1940	78.6	12.7	469.0	8.7	321.9	
1941	85.3	10.7	469.0	4.0	175.2	
1942	91.9	7.8	459.0	0.3	15.5	
1943	94.3	5.6	439.0	0.1	12.7	
1944	96.8	3.1	333.0	0.1	12.4	
1945	97.5	2.4	333.0	0.1	12.1	
1946	98.9	1.0	178.0	0.1	11.8	
1947	98.7	1.2	148.0	0.1	11.6	
1948	98.7	1.2	198.0	0.1	9.3	
1949	98.0	1.9	298.0	0.1	9.3	
1950	96.7	2.9	437.8	0.4	61.9	
1951	97.2	2.4	365.4	0.4	56.3	
1952	97.3	2.3	343.4	0.4	53.1	

(in $millions Canadian)

SOURCES:–*Canada Year Book, Public Accounts of Canada*, various years.(March 31)
**– includes 5% 1917-37 War Loan payable in Canada and New York, 5% War Loan 1915-35 and 2 year, 4% Treasury Note due 1 December 1932.
Net of sinking funds.

During the Depression, there does not seem to have been any concerted effort to reduce the Dominion's foreign indebtedness at least during the Bennett years, although it is true that the direct optional-payment bonds were retired. With the Bank of Canada's establishment, the understanding that debts denominated in foreign currencies were less controllable, in terms of exchange fluctuations, and therefore less desirable than domestic

placements, was articulated in the third *Annual Report.*

> Any considerable reduction of our foreign debt must, in any case, take many years, in view of the magnitude of the task. Considering only Dominion and Provincial Governments' direct and guaranteed debt, and that of the Canadian National Railways, there is still about $1,307 millions payable abroad, and not only that, but an even larger total of debt– $1,379 millions to be exact– carries the option of payment in one or more foreign markets as well as in Canada. *Our efforts should, of course, be directed first towards a reduction in such optional payment bonds.* Certainly it is undesirable that any additions to this class of indebtedness should be made from the point of view of the Canadian economy as a whole.[664]

Another factor having an impact on Canada's borrowing in New York was the New Deal legislation which established the Securities and Exchange Commission. Canada, which had always been a respected borrower in New York, was required to file a special prospectus including the provision of a legal opinion. The implementation temporarily led the Dominion to put off certain refunding operations in the American market (See Table 8.2).

The Second World War not only cut off England's financial resources but led to the repatriation of some $300 million of Dominion and C.N.R. securities held by U.K. citizens and institutions.[665] On top of that transfer was a billion dollar contribution in the form of a gift to enable England to meet part of her foreign currency shortfall.[666] Canada's role in aiding England to purchase supplies in the United States was made more difficult by the invocation of the *Neutrality Act* sanctions which prevented Canada from raising new funds in New York until Pearl Harbour. In 1942, the Dominion was again able to raise fresh cash on Wall Street borrowing $90 million in 1943. Thereafter, Canada's need for dollars

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[664]Bank of Canada, *Annual Report, 1937,* (Ottawa: 22 February 1938), p. 14. (emphasis added)

[665]*The War Appropriation (United Kingdom Financing) Act, 1942,* 6 George VI, Statutues of Canada, 1942, Chapter 8 .

[666]*The War Appropriation (United Nations Mutual Aid) Act, 1943,* 7 George VI, Statutes of Canada, 1943, Chapter 17. Mackenzie King saw the hand of the Bank of England in this transaction and thought the Bank of Canada too pliant in these negotiations. King did not want to "give to the British Treasury in advance the intimation, as he (Ilsley) wished, of what we are proposing to do in making a virtual gift of a billion dollars to Britain but to allow me to hold this card in making pleas which I might have to make with Churchill and Roosevelt alike for some recognition of what Canada is doing in discussions pertaining to our right to participate in at least the direction of our own part of the war effort, and not to have it taken altogether out of our hands." Cited in J.L. Granatstein, *Canada's War. The Politics of the Mackenzie King Government, 1939-1945,* (Toronto: 1975), p. 190. In a note to his successor James Coyne, Towers acknowledged his role, as early as August 1941, in recommending to Ilsley that non–interest bearing loans and a gift should be made to the United Kingdom. Towers Memoranda, No. 401, 2 August 1941, "Major Considerations relating to sale of securities," and "Note for Mr. Coyne," 28 January 1955, with Towers Memoranda, No. 402. *Bank of Canada Archives.*

eased and by 1944 a favourable balance of trade with the United States did not necessitate a return to New York's capital market.

The huge domestic borrowing operations combined with repatriation, left most of the debt domiciled in Canada at war's end.(Tables 5.8 and 8.1) A process set in motion during the Great War, was completed during the Second World War. After 1945, new cash foreign borrowings were initiated by a concern for the value of the Canadian dollar, the latter day equivalent to protecting one's "gold reputation", and not by the Dominion's inability to borrow domestically. The small rise after 1945 in foreign-pay debt is a reflection of the large retirement of domestically held debt, not the growth of foreign loans except during the 1948-1949 drawing on Eximbank's credit facilities and the 1950 U.K. borrowing.

The initial *raison d'etre* for borrowing abroad was for economic development, to foster territorial expansion and consolidation through railway building. This reliance on London was also a reflection of the unsophisticated nature of Canada's bond markets prior to 1914. The Great War necessitated a re-evaluation of the role of London in meeting the Dominion's borrowing requirements. Thereafter, foreign borrowing was, in the main, refunding of maturing loans. There is some evidence that during 1931, the Dominion sought to borrow in New York to protect Canada's gold reputation.[667] This is perhaps the first acknowledgement that foreign borrowing was no longer simply a matter of raising funds to finance infrastructural development or ongoing government expenditures.

Market Conditions and Timing of Issues

In assessing whether leverage was applied to Dominion Government officials when they discussed foreign issues, a survey of documents at the Public Archives of Canada and the Bank of Canada Archives generated forty-one reports, letters, phone conversations and meetings between Bank officers and foreign bankers, central bankers and investment bankers. Nearly one half of these discussions related to the assessment of "market conditions", that is, the pros and cons of coming to market this week, this month, this year, etc. For instance, in March 1931, Watson Sellar advanced proposals for a New York issue of $100,000,000 "to safeguard our gold exchange position," noting that Canada was

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[667] Watson Sellar, "Memorandum for Mr. Bennett," 12 March 1931, *Public Archives of Canada*, RG 19, Volume 592, File 155-30, Volume 2.

suffering from a "bad reputation" on Wall Street. Instead of taking a more innovative approach in coping with the advancing depression through currency depreciation and domestic monetary expansion, Sellar and Bennett pursued the orthodox course of maintaining "investor confidence" by protecting Canada's gold reputation. This bad reputation was not based on politics, but on the dreary economic news emanating from the Dominion Bureau of Statistics. Sellar, knowing the market's reaction to poor economic results, recommended that we "feed out short items every two or three days dealing with our financial position, and arrange with some of the press boys that they put the stuff on the wires in their own names. I would also urge that a censor be placed on the release of the stuff by the Bureau of Statistics."[668] This proposal, reminiscent of C.I.A. operating procedures in Latin America, demonstrates the significance of controlling and disseminating financial news to Canada's foreign creditors. The implications for Canada's credit rating and borrowing costs were abundantly clear– bad news meant falling bond prices and higher interest rates. This manipulation of the financial reports by the Government was the subject of a lengthy tirade by Canada's most astute observer of public finance, Professor Donald MacGregor. In an article published in *The Canadian Forum*, MacGregor charged:

> It is not easy to follow the changing position of Canadian finance as long as the federal authorities continue to suppress the usual monthly figures of revenue, expenditure and debt. Suppression of financial returns began last spring, and continued until August when quarterly figures of revenues and expenses *(but not of debt)* for the first quarter of the fiscal year were published. Early in January the accounts for the three months ending December were released, but no figures whatever of the net debt have been published since March 31, 1932. It is a sad reflection upon the alertness and courage of whatever financial critics there are in the opposition, and in the press of the country that Ottawa has been able to suppress the usual publication of such important statistics for nearly a year without being exposed. If the weekly returns of the British exchequer were delayed as much as a fortnight, the whole Empire would know about it. But the Canadian figures are delayed six months and nothing is said.[669]

Thus, the Government successfully suppressed the data on the net debt for months, data which from the standpoint of any investor was central in making an intelligent judgment whether to purchase bonds or not. Management of financial information was therefore an integral component in achieving lower borrowing costs.

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[668] *Ibid.*

[669] "The Threat of Financial Crisis," *The Canadian Forum*, Volume 13, No. 150 (March 1933), p. 206. (emphasis added) .

In September 1931, Bennett was apprised by his acting deputy of the "disorganized" state of New York's bond market fearful of a collapse of American savings banks. Given this situation, Sellar thought it was an opportune time to come to market for the view was widely held that Canadian credit was excellent. It was certainly excellent when compared with Latin American nations which were defaulting left and right about this time. However, when England went off gold, foreign borrowing operations were cancelled in light of the sharp rise in short term rates in New York during October.[670] In 1932, assessments of the New York market took into account the November presidential elections. In order to avoid unsettled market conditions, it was suggested that the refunding of November and December maturities be settled before mid-October.[671] It was believed that the uncertainty of the result would unsettle the markets for the two or three weeks leading up to the election and, depending on the outcome, for several weeks thereafter. Subsequently, $60,000,000 in one year treasury notes were sold on October first.

In London, after the success of the huge domestic refunding loan in the summer of 1932 signalling a return to lower, long-term rates, the Canadian High Commissioner was advised that the time was now right to come to market.

> if carried through at once, would meet with a favourable reception in the City of London, which point we feel to be of tremendous consequence inasmuch as it entails Canada's first entry into the London market as a borrower since pre-war days, and therefore, the success is of utmost importance....
> We trust that you and your Government will appreciate the fact that *only an extraordinary abundance of idle funds in London,* enable us to put up such advantageous terms, and we take this opportunity of stressing the fact that absolute secrecy on this matter is essential to its successful conclusion.[672]

What was secret about this operation seemed to be the rather peculiar recommendation from Messrs. Rowe, Swann and Co. that "an understanding that a substantial portion of the proceeds would be devoted to the purchasing of British Rolling Stock for use on the State Railways" would be of considerable assistance in making the issue a success.[673] Ferguson's

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[670] Watson Sellar to R.B. Bennett, "Re. Interest Rates," *Public Archives of Canada*, RG 19, Volume 592, File 155-30, Volume 2.
[671] Watson Sellar, "Memorandum to Minister," 9 September 1932 and "Memorandum for the Minister re. Financing 1932," 12 September 1932, *Public Archives of Canada*, RG 19, Volume 592, File 155-30, Volume 2.
[672] Rowe, Swann & Company to Canadian High Commissioner, Hon. George Ferguson, 31 January 1933, *Public Archives of Canada*, RG 19, Volume 591, File 155-24A, "Dominion Financing in London-General File." (emphasis added)
[673] *Ibid.*.

diplomatic reply read, in part, "I am quite sure, however that the desire of the Canadian Government will be to buy here anything they cannot procure at home."[674] This exchange can be considered the only crude *quid pro quo* demanded in the documents on foreign borrowing examined.

Another instance of market advice from London came from Nivisons and Company in regard to the possible conversion of the 3 1/2% stock of 1930–1950. Nivisons stated

> The market is at present in position to deal with further large loans and we expect that there will now be a pause *and that the Bank of England will not favour any more issues for the moment.* Recent events in the Dominion do not make the present moment any more opportune. At the same time the British Government remains firm and money cheap and it is confidently expected that after a rest from new loans the way will be open again when we will immediately advise you.[675]

The preceding advice incorporated what Nivisons believed to be the stance of the central monetary authority, the Bank of England. Naturally, one of the most important variables in timing an issue was to avoid conflict of dates with the expected treasury financing. As the market could absorb only so much financing each day, it was essential for the borrower to know the dates that were relatively free of major corporate and governmental bond issues.

Another instance of political factors obtruding on the timing decision is contained in correspondence from Nevil Ford of The First Boston Corporation to Clark. Ford advised Clark in December 1935 to file a prospectus early with the S.E.C. since "As you doubtless know, our Congress goes into session right after New Year's and there is every indication that a great many bills will be introduced which are liable to be disturbing to the financial markets."[676]

After the Bank of Canada commenced operations, it acted as the main conduit for foreign market information between bankers and the Dominion. In August 1938, G.L. Harrison, Chairman of the Federal Reserve Board of New York advised Governor Towers "that an issue during or very shortly after the elections might encounter a disturbed

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[674]Ferguson to Rowe, Swann and Co., 2 February 1933, *Public Archives of Canada*, RG 19, Volume 591, File 155–24A.
[675]Nivisons & Company, Enclosure in W.A. Bog, Bank of Montreal to W.C. Clark, 6 February 1935, *Public Archives of Canada*, RG 19, Volume 3978, File F–1–5–1, "Deputy Minister's Files".(emphasis added).
[676]Nevil Ford to W.C. Clark, 20 December 1935, *Public Archives of Canada*, RG 19, Volume 3978, File 1–1–6, "Dominion Financing, 1935–36."

market, although he did not make this in any way a prognostication."[677] That September, Towers observed "if the London situation continues so uncertain that no plans can be made in respect to that market at this date, we will have to evolve some arrangement which leaves a certain latitude and does not put us in a position of having a London commitment...."[678] In October, with the European situation so unpredictable, the Governor sought some direction from Harrison who cautioned Towers that "it was desirable for us to keep away from the market in December, or even in the last days of November, in our interests. In the event of a clash, we would probably be the losers."[679] Based on this inside information, the Dominion wisely respected the wishes of the Federal Reserve and went to market on the fifteenth of November. Borrowing at the same time as the U.S. Treasury was entering the market would have been a disaster with the Dominion being "crowded out." On this particular occasion, events in Europe conspired to dampen the market with the result that Morgan Stanley was forced at the last moment to drop the sales price twenty-five cents. This occurence is a further illustration of the market's acute sensitivity to political crises.[680]

With the virtual closing of New York to the Dominion and with the introduction of exchange controls during wartime, the need for daily or weekly market information from these centres was unnecessary. With the resumption in the transnational mobility of capital after the war, market information became important especially during the negotiations on refinancing or raising new loans. In December 1947, Towers met with Sproul of the Federal Reserve to discuss interest rate conditions. Sproul indicated that the banks were short of cash, meaning sales of government paper to the "Fed" would bring about a "firming" of interest rates. This upward trend became apparent in subsequent discussions with private bankers who were not in a mood to lend long at rates which Towers considered reasonable in the circumstances.[681]

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[677]Towers Memoranda, No. 162, 26 August 1938, "Preliminary Memorandum in regard to financing of loans maturing Jan. 1–July 1, 1939," *Bank of Canada Archives.*
[678]Towers Memoranda, No. 171, 15 September 1938, *Bank of Canada Archives*, p. 1.
[679]Towers Memoranda, No. 187, 21 October 1938, "Discussions re. Canadian Financing New York, Oct. 18th and 19th, 1938," *Bank of Canada Archives.*
[680]Towers Memoranda, No. 196, 15 November 1938, *Bank of Canada Archives.*
[681]Towers Memoranda, No. 560, 4 December 1947, "Notes re. discussions with banks and others in New York in regard to Canadian financing," *Bank of Canada Archives.*

The principal reasons then for gathering information about foreign market conditions was in order to issue bonds at the most opportune time. The estimation of the most appropriate time is based on several factors including the avoidance of conflict with major borrowers, notably the national government, avoiding dates which correspond to elections or the opening of legislatures, and being prepared to enter the market the minute rates seemed most favourable.

The foregoing description of an often extensive information gathering process is consistent with the debt management maxim of keeping interest costs to a minimum. Had the Dominion entered these markets "willy-nilly", there would certainly be cause for alarm that Canadian taxpayers were paying more than they should for foreign-denominated funds. By employing Morgan Stanley and Nivisons, the Dominion was receiving possibly the most respected advice on the street. This advice, along with access to Reserve Board thinking meant the Dominion was able to avoid any embarrassing clashes in timing.

TABLE 8.2

Synopsis of Canadian Loans Issued Abroad, 1930-1950

Date Issued	Term	Where Payable	Amount	Coupon Rate %
July 1	1930-50	London	137,058,841	3.5
October 1	1930-60	New York	100,000,000	4.0
October 1	1932-33	New York	60,000,000	4.0
July 1	1933-34	New York	60,000,000	4.0
September 1	1933-58	London	73,000,000	4.0
May 1	1934-55	London	48,666,667	3.25
September 1	1934-35	New York	50,000,000	2.0
August 15	1935-45	New York	76,000,000	2.5
January 1	1936-39	New York	40,000,000	2.0
January 15	1936-41	New York	48,000,000	3.25
January 15	1937-44	New York	30,000,000	2.25
January 15	1937-67	New York	55,000,000	3.0
November 15	1938-68	New York	40,000,000	3.0
May 1	1939-41	New York	20,000,000	1.25
May 1	1941-43	New York	10,000,000	2.25
January 15	1943-48	New York	30,000,000	2.5
January 15	1943-53	New York	30,000,000	3.0
January 15	1943-58	New York	30,000,000	3.0
December 1947	Eximbank credit	New York	50,000,000	2.25
August 1	1948-63	New York	150,000,000	3.0
July 1	1949-63	London	54,812,961	3.25
September 1	1949-74	New York	110,000,000	2.75
September 15	1950-75	New York	52,500,000	2.75

SOURCES: *Public Accounts of Canada*, various years; *Canada Year Book*, various years.

The Alberta and Western Situation

The only real protection the Dominion borrower might have against a poor foreign market reception was to acquire the best market information available. Foreign market fluctuations can be viewed as uncontrollable, exogeneous factors which, from the standpoint of the Dominion issuer, called for experienced judgements on the information gleaned from reports. The segment of foreign markets trading Canadian bonds was also sensitive to news about Canada's trade balance, national income, government revenues and expenditures, and the domestic political situation. All these factors were, to some extent, manageable by Dominion officers; a case in point being the dissemination of financial and economic data.

During the period under review, the most damaging internal political variable was the election of William Aberhart's Social Credit government and the fiscal position of the three prairie governments. From an international creditor's perspective, it was felt that the

Dominion, especially the new central bank, should make every effort to prevent Alberta's subsequent default from spreading east and west.

London's Reaction

Shortly after the Bank opened for business, Towers wrote Montagu Norman, Governor of the Bank of England outlining the difficulties facing the Western Provinces and probing Norman on their possible consequences for Canadian credit. "In a way," wrote Towers, "it is foolish for the Dominion Government to continue to foot the bill on the present basis. It simply means that the Dominion Government is indirectly paying interest at higher rates."[682] More particularly, Towers wished to know the impact on the Dominion's credit rating should the federal government step in to guarantee provincial refinancing. This was an initial sounding taken for the idea of a type of Loan Council scheme.

In London, the Alberta default did not have a major effect on Canadian credit as might be expected. Towers was correct in observing that Alberta would be treated as an exceptional case. Lester Pearson in a June 1936 dispatch to O.D. Skelton, Undersecretary of State for External Affairs, noted that British anxiety centered on Alberta while Dominion bonds were trading nearly on a par with Exchequer issues. Pearson reported that questions were being asked of the Secretary of State for the Dominions as to the steps being taken by His Majesty's government to protect the holders of Alberta and City of Vancouver bonds.[683] Towers visited London that Fall and met with Sir Montagu Norman. Sir Montagu expressed the view that "any form of western default (was) unwise," and argued for efforts to keep these debtor provinces afloat.[684]

These conversations and others illustrate the close connection foreign bondholders drew between dominion and provincial credit. There also appeared to be a

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[682]G.F. Towers to Governor Norman, 22 March 1935, *Bank of Canada Archives*, PF2–"Provincial Government Financing–Alberta, 1935, 1936."

[683]L.B. Pearson to O.D. Skelton, "Recent British Press Opinion on Canadian Credit and Finance," 17 June 1936, *Public Archives of Canada*, RG 19, Volume 591, File 155–24A. Another complicating factor in the Dominion's credit standing in London several years later were the activities of Sir Edward Beatty and Sir Edward Peacock of the C.P.R. to thwart C.D. Howe's plan to reorganize C.N.'s capital structure. According to J.W. Dafoe, Beatty launched "an organized campaign to damage the credit of Canada on the ground of the railway situation, in the hope that the government can be intimidated to yielding to Sir Edward Beatty's demand. I was told that no Canadian can stir about in London without encountering this propaganda." Recounted in Robert Bothwell and William Kilbourn, *C.D. Howe: A Biography*. (Toronto: 1979), p. 99.

[684]Towers Memoranda, No. 43, "Conversation with Governor Norman, London, November 1936," *Bank of Canada Archives*.

set of *expectations* built up about Ottawa's decision–makers; expectations that aberrant or deviant behaviour, namely default, repudiation, or social credit, must be discouraged, and preferably eliminated. A document prepared by the Finance Department for the 1937 Imperial Conference entitled "Interest Reduction Legislation of the Province of Alberta", appears to support our contention that a climate of expectations on the part of foreign bondholders and governments was build up about Ottawa decision–makers that the Dominion should act to police the unorthodox activities of certain provincial governments.

> Though the power of disallowance has been frequently exercised in the past, it is important to remember that no provincial statute has been disallowed in recent years. A different conception in regard to the disallowance of provincial statutes has grown up and it is now widely believed that disallowance is not the proper remedy except in very exceptional cases. If a provincial statute is unconstitutional, the remedy lies in attacking the validity of the legislation by an action taken in the courts in the ordinary way. If, however, a provincial statute is clearly constitutional but is objectionable for other reasons it is one of the consequences of the granting of responsible government that redress should lie with the electorate of that province. Any other view would place the Dominion in an intolerable position and require it to judge of the propriety of statutes passed by a province in relation to the exclusive legislative authority assigned to the province. *The Dominion does not admit, however, that the power of disallowance is obsolete and could not now be exercised if a proper occasion arose but it should be understood that the power of disallowance is likely to be exercised only in exceptional cases when no other remedies are available, and the interest of the Dominion is directly affected.*[685]

Here the Dominion was clearly hedging its bets– it could plead "provincial rights" when it came to protecting Duplessis's attacks on Communists and the Jehovah Witnesses or it could disallow legislation which directly affected the Dominion's interests *viz.* its credit standing. Foreign investors were certainly influential in pressing the Dominion to act "responsibly", to use its constitutional powers and, if need be, its financial resources to safeguard the capital of foreign debtholders.

Wall Street's Reaction

In addressing himself to the problem of best protecting the integrity of the Dominion's and the nation's credit, Towers drew a distinction between the default incident in Alberta and the situation in the other western provinces. Towers thought it "penny wise and pound foolish" not to preserve the Dominion's and the country's credit intact by meeting, on an ad hoc basis, calls from the other western provinces for loans to meet

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[685] June 1937, PF2 "Provincial Financing– Alberta 1937–1942," *Bank of Canada Archives.* (emphasis added)

approaching principal and interest payments.[686] This fundamental requirement to protect foreign bondholders' Canadian investments was based on Towers' reading on the bondholders' preoccupations:

> Investors in that country (the United States) have bought western bonds right up to recent times on the general assumption that they were Canadian obligations, and therefore safe. Doubtless they should have exercised more discrimination, but not having done so, I am afraid that default will change their attitude toward all Canadian obligations from general faith to general distrust. They will fear– perhaps with a good deal of justification– that the default complex will move east. No one should attempt to lay down the law on a matter of this kind where the psychology of markets plays such an important part, but I have no hesitation in saying the situation I have outlined is the *probable* one. United States investors in Canadian western bonds constitute a very influential group, and if a general western default makes them form an adverse opinion on Canadian securities as a whole, the situation would be extremely serious and damaging for the Dominion.[687]

In short, the Dominion was caught between the fears of foreign investors and the division of powers which gave Ottawa no constitutional authority whatsoever to police provincial debtors. It seems reasonable to presume that the Loan Council concept[688] was a direct response to foreign bondholders' anxieties offering a suitable institutional framework to monitor provincial credit–worthiness and to protect the Dominion's credit standing. [689]

In another encounter between a government official and a New York investment banker, the connection, in the eyes of foreign capital, between Dominion and provincial

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[686]Towers Memoranda, No. 14, 18 April 1936, "Memorandum in regard to Loan Councils," p. 5. *Bank of Canada Archives.*

[687] Towers Memoranda, No. 14, 18 April 1936, pp. 3–4, "Memorandum in regard to Loan Councils," *Bank of Canada Archives*

[688]The Loan Council sought to institutionalize the ad hoc arrangements that had grown up during the Depression whereby the Dominion periodically advanced sums to the provinces for relief to meet payments on principal and interest. Modelled loosely after the Australian Loan Council, the "council", in effect nine separate bodies, one for each province, was to be composed of the Governor of the Bank of Canada, the Dominion's Finance Minister and the Provincial Treasurer of the province concerned. To give effect to the proposal a joint resolution of the Commons and the Senate was needed to amend section 92 of the B.N.A. Act. The proposed amendment would have authorized the "parliament of Canada to guarantee the payment of principal, interest and sinking fund of any securities which any province of Canada" issued. Should default occur, the Government of Canada could meet payments to creditors out of subsidies normally granted to the province in default. Senate, *Debates*, 18th Parliament, 1st Session, 14 May 1936, pp. 2795–2796.

[689]Along the same lines in order to work this domestic problem out amicably between the provinces and the financial interests, Towers proposed a *refunding corporation* whose stock would be owned by the Dominion, the central bank, and private finance capital. This new corporation would enable provinces to introduce legislation to call in bonds with the highest coupon rates for redemption. However, this proposal never received the support of the financial community nor apparently the Department of Finance. Towers Memoranda, No. 31, "Notes on a Refunding Corporation," 20 October 1936, *Bank of Canada Archives.*

credit was often raised. In December, Clark drafted the following memorandum recording his discussion with Harry Morgan of Morgan Stanley.

> I had a private discussion with Mr. Morgan in regard to the Western provincial situation, pointing out the fact that there was *no legal connection between our credit and provincial credit* (which he admitted, although stressing *that there was a definite psychological connection which was of importance to the investor*), and pointing out also how difficult it would be to make any statement which would not involve one in speculations that might prove untrue or that might not lead one to go on from a discussion of provincial credit to municipal credit, to almost anything under the sun.[690]

When visiting Washington and New York in April 1939 prior to the sale of $20,000,000 in two year notes, Towers sounded out Washington official Alvin Hansen and Canadian born economics professorJacob Viner and officials at Morgan Stanley on the effects of a possible Saskatchewan and City of Montreal defaults. Hanson and Viner were "unanimous that a combination of the two would be very bad."[691] This seemed to confirm the conventional wisdom in the federal bureaucracy that default must be contained in the interests of the Dominion's foreign and domestic debt management operations.

In attempting to ensure that defaults would not spread east, the Dominion Government provided considerable sums to Saskatchewan and Manitoba for relief and the maintenance of interest payments. Indeed, the tax rental scheme worked out during the early part of the war was designed to avoid an expected default by Manitoba in June 1941, the arbitrary reduction of interest by Saskatchewan which, when combined with municipal defaults and the Alberta aberration would have a decidedly negative impact on the Dominion's credit at a time it required vast sums of cash.[692] In Alberta's case, some aid was forthcoming but it was given sparingly. Alberta's requests made directly to the central bank were always spurned with the rider that advances would only follow a reconciliation with bondholders.[693]

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[690]W.C. Clark to Charles Dunning, 31 December 1936, "Discussion with Harry Morgan," *Public Archives of Canada*, RG 19, Volume 3978, File F-1-7, "Deputy Minister's Files".
[691]Towers Memoranda, No. 251, 18 April 1939, "Visit to Washington and New York, April 15-17, 1939," *Bank of Canada Archives*.
[692] Towers Memoranda, No. 377, 2 March 1941, "Advisability of Some Declaration of Policy Respecting Dominion and Provincial Fields of Taxation," *Bank of Canada Archives*.
[693]For instance J.A.C. Osborne, Deputy Governor, Bank of Canada to Charles Cockcroft, Alberta Provincial Treasurer, 28, 30 October 1936, *Bank of Canada Archives*, "PF2-Provincial Government Financing, 1935, 1936."

This trying time in the early history of Canada's central bank lends empirical support to Professor Mallory's assertion of Dominion "power and influence to police Canadian borrowers in order to perserve the goodwill of the financial interests which controlled the flow of funds."[694] This control was incomplete to the extent that Clark and Towers were unable, through the Loan Council initiative and the power of disallowance, to wrest away from the provinces their independent powers to issue debt instruments under the sole credit of the province. The core state institutions, the central bank, Department of Finance, and Department of Justice behaved in a manner consistent with the objectives of minimizing interest charges in the context of Canada's continuing dependence on outside foreign capital. These institutions were not neutral in this conflict but acted to preserve the credit of the Dominion and in so doing the rights of metropolitan financial interests.

After-tax Rates of Return

American and British investors, like their Canadian counterparts, sought as high a return on invested capital as possible, taking into account foreign withholding taxes. The existence of withholding taxes led necessarily to a discounting of the bonds meaning that higher rates would be demanded by foreign investors. Simply put, a bond subject to tax could be sold to yield 4.5 per cent whereas a bond exempt from tax might sell to yield 4 per cent to the holder. Undertakings by the Government or corporations that bonds issues would be free of tax were an integral part of foreign borrowing.[695] Canadian companies borrowing abroad frequently covenanted to reimburse lenders up to a specified amount if taxes were imposed during the term of the financial contract. During the Depression, worries of foreign investors surfaced several times that the cash-poor Dominion and provincial governments might impose special withholding taxes. For example, in March 1933, Edgar Rhodes proposed a five per cent tax on municipal and provincial bond interest payable in Canadian and foreign currency including payment of interest on optional-pay bonds.[696] Predictably, howls were heard from the financial press as well as from Quebec Premier Taschereau that this measure would harm Canada's and

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[694]*Social Credit and the Federal Power in Canada,* (Toronto: 1976), p. 58.
[695]For instance the $50,000,000 of one year promissory notes issued by the Dominion in New York in September 1934 were tax exempt in the hands of foreign holders. *Public Archives of Canada,* RG 19, Volume 595, File 155-34-60.
[696]House of Commons, *Debates*, 17th Parliament, 4th Session, 21 March 1933, p. 3225.

Quebec's credit.[697] On the London exchange, Canadian securities trading was suspended. At home Bennett and Rhodes were attacked for violating "sanctity of contracts" on the antideluvian logic that once a contract was signed then the holder had a right to be free of taxes for the duration of the contract. Taken to the extreme, this "logic" would have prevented the Government from ever taxing the interest on perpetual debenture stock. The government apparently had no right to tax because that interfered with freedom of financial contract.[698] After several weeks of such hysteria, Rhodes and Bennett amended the proposal and instead imposed a five per cent tax on dividends and interest received from Canadian debtors by non-residents *except* interest paid to non-resident holders of Dominion bonds.[699]

Anxiety concerning the possible levy of a withholding tax in 1934 prompted R. Nivison and Company, the London investment house, to write the Bank of Montreal. Nivisons stressed the vexatious uncertainty surrounding provincial and municipal bond taxation and called for a Dominion

> understanding with the Provinces that no Dominion taxation of any kind will be levied on holders of Provincial Stock and Bonds who are not resident in Canada. As soon as the policy of the authorities here permits of Provincial and Municipal borrowing, *it must surely be in the interests of the Dominion of Canada to afford every facility for these operations in London,* and to do this it is essential that the Provinces should be able to give the same undertaking to the investors as the Dominion itself...
> English investors have become insistent on adequate protection, from such taxation, and there is little prospect of their being induced to invest their money in stocks which are not safeguarded in the manner suggested above. [700]

Wariness then had become the order of the day in London as it had become in Canada. Nivisons strongly intimated that Dominion bond prices would be discounted should the Dominion or provincial governments make moves to penalize the foreign investor. This request also reaffirms our hypothesis that, in the eyes of the foreign creditor, Dominion and provincial credit were virtually synonymous, at least as far as "market psychology" was concerned.

A similar response to proposed legislation in the April 1941 budget to tax foreign-pay bonds greeted a proposal of Walter Gordon's, then assistant to Minister Ilsley

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[697]*The Monetary Times*, "Lack of Clarity in Budget Legislation," 7 April 1933, p. 6.
[698]*The Monetary Times*, "This Dominion Must Honour its Contracts," 14 April 1933, p. 6.
[699]*An Act to amend the Income War Tax Act*, 23-24 George V, Statutes of Canada, 1933, Chapter 41, Section 9(b).
[700]R. Nivison & Co. to General Manager, Bank of Montreal, 25 April 1934, *Public Archives of Canada*, RG 19, RG 19, Volume 591, File 155-24A. (emphasis added)

for a 15 per cent withholding tax.[701] The proposal was roundly condemned in domestic and American finance circles and substantially modified. Towers felt "the lender may well regard the payment of a lesser sum as a form of repudiation. In some cases, of course, companies issuing bonds have covenanted to refund any tax which might be deducted, at least up to a specified percentage. To the extent that this takes place, Canada saves no U.S. funds, and the unintended taxation is placed on Canadian companies."[702] George Spinney, National War Finance Committee Chairman believed the tax was "a bad one, and should be cancelled."[703] At a meeting on May fifth with Gordon and Ilsley present, Towers delivered a lecture apprising them of the fact that substantial *refunding* operations were being conducted which would be "adversely affected by the narrowing of the market which results from charitable organizations, mutual life companies, banks and others not being interested because of the tax."[704] This understanding of the motivations of foreign finance capital on the part of the Bank was affirmed over the next several days as Towers received a half a dozen phone calls from major U.S. institutions demanding a reversal of the proposal. One life insurance executive told Towers "they would have to whittle down their (Canadian) holdings– as a matter of self-interest, and not in any vindictive spirit."[705] Harry Morgan (Morgan, Stanley) reported that the Investment Bankers' Association and the National Association of Security Dealers were contemplating the lodging of a strong protest.

It was not only foreign capital that was opposed to the change. A.R. Wood, President of the Sun Life Assurance Company, a firm having very large investments and operations in the United States, feared reprisals by some states leading to the disqualification of Canadian bonds for deposit under their insurance regulations.[706] Chester Walters, Ontario Deputy Provincial Treasurer representing the constituency of major provincial debtors was also upset when he reported "the bottom had dropped out of the

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[701]House of Commons, *Debates*, 19th Parliament, 2nd Session, 29 April 1941, p. 2352. As the Minister pointed out this new tax of 15 per cent was still lower than the 16.5 per cent tax imposed by the United States government.
[702]Towers Memoranda, No. 389, 6 May 1941, "Discussions re. application of 15% withholding tax to interest payments in foreign currency," p. 5. *Bank of Canada Archives*
[703]*Ibid.*
[704]*Ibid.*
[705]*Ibid.*
[706]Towers Memoranda, No. 390, 7 May 1941, "Further Comments on the subject of application of a 15% withholding tax to bonds payable in U.S. dollars," *Bank of Canada Archives.*

market for Ontario bonds."[707] After the markets' reaction and extensive discussions, the Government decided to water down the proposal by excluding interest on bonded indebtedness from the tax. Instead the legislation passed placed a 15 per cent withholding tax on non-resident royalties, rents and similar payments deriving from the use of property or patents.[708]

This episode, which reads like a dress rehearsal for the budgets of Walter Gordon and the 1963 Interest Equalization Tax, confirms the Bank's conservative stance in these matters and its support for the sanctity of financial contracts. This high drama is illustrative of the complex web of alliances between domestic borrowers dependent on a stable foreign market (provincial governments), domestic institutions with major operations abroad (banks and insurers), and foreign, private capital whose near instanteous and universally hostile reaction was able to thwart the Government's desire to increase its take from taxation. The international financial community had a very powerful stick with which to strike at the Canadian government– discounting the bonds trading in the secondary market. Although the Dominion itself was relatively less reliant on these markets, the provinces' requirement for funds made the Dominion reluctant to challenge these financial interests. While it is quite true that in April 1941, Canadian governments could not borrow new cash abroad, perhaps explaining, in part, this momentary lapse by policy advisors in Finance, the substantial refunding operations which occurred made Provincial treasurers and their deputies nervous regarding any taxation proposal of this kind.

Term and Loan Arrangements

Foreign investors, particularly banks, were keenly interested in the term to maturity (liquidity) and interest rates offered on loans. In the broader capital markets of London and New York consisting of hundreds, not dozens of large brokers, dealers, and bankers, the type of offering– *a private versus public offering* was also a critical determinant in the cost and success of a borrowing operation.

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[707] Towers Memoranda, No. 389, 6 May 1941, "Discussions re. application of 15% withholding tax to interest payments in foreign currency," *Bank of Canada Archives*.
[708] *An Act to amend the Income War Tax Act*, 4–5 George VI, Statutues of Canada, 1941, Chapter 18, Section 22.

Liquidity

When arranging a New York issue in 1938, Towers was informed by Charles Batchelder of the Chase Bank that the banks would be unwilling to advance funds beyond five years.[709] After taking soundings on the street, Clark, Towers, and Henderson decided against the short term private placement with banks reasoning "the Government should borrow long when rates are low, and turn to short term borrowing when rates stiffen."[710] Instead, a twenty year issue of $40,000,000 was marketed at 3 per cent.

During November and December 1947, discussions on the feasibility of a *private placement* with New York banks were held due to the urgency of the situation. Winthrop Aldrich of the Chase Bank (and a son-in-law of John D. Rockefeller) advised Towers the banks would be *unwilling to lend for more than 4 years* at approximately 2.5 per cent. Towers thought that a two year maturity was no good and that the $75 million proposed

> hardly seemed a respectable amount for Canada to do in the circumstances. He (Aldrich) did not agree on the question of amount, but said that he would reopen the thing with the banks on the basis of three, four, and five year maturities. In that case the rate would be higher. National City had suggested 2 3/4 per cent on the two, three, and four year deal. I said that I was sure that a 2 3/4 per cent could not be accepted by the Canadian Government. Aldrich said it might be 2 5/8. I said I felt that was still high, and that 2 1/2 was the right level.[711]

Towers later met with Messrs Burgess and Pfeffer of National City Bank who also doubted that a longer term tranche at 2 1/2 per cent could be arranged. Towers' record indicates that arranging a *private* as opposed to a *public placement* gave the lenders more opportunity to exert leverage with respect to the price.

> Pfeffer spoke to me alone on my way out, and said that in confidence he wished to express the view that the sounding out of the banks was not a very good procedure from the Canadian standpoint. The banks were in a frame of mind to ask questions, express doubts and generally hum and haw. If on the other hand we did a public issue, it was much more likely that people would buy on their general belief in Canada's credit standing without bothering too much about details.[712]

The Government eventually decided to borrow from the Eximbank at 2.25 per cent over a seven year period.

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[709]Towers Memoranda, No. 187, 21 October 1938, "Discussions re. Canadian Financing New York, Oct. 18th and 19th, 1938," *Bank of Canada Archives.*
[710]Towers Memoranda, No. 192, 8 November 1938, "New York Loan," *Bank of Canada Archives.*
[711]Towers Memoranda, No. 560, "Notes re. discussions with banks and others in New York in regard to Canadian financing," 4 December 1948, *Bank of Canada Archives.*
[712]*Ibid.*

This series of meetings brings out the contrast between a quickly arranged loan priced slightly above market price and a public issue with broad distribution involving higher underwriting fees. In August 1948, the Dominion again arranged a private placement with three major U.S. life insurance companies to repay the Eximbank loan. These two essentially private funding operations precluded participation from other U.S. investment houses which prompted Nevil Ford of The First Boston Corporation to counsel the Dominion to refund callable issues through a public placement.

> Many investors are greatly perturbed by increasing restriction of opportunity to invest in Dominion securities......we and group including Canadian houses who have served Dominion in the past and consistently provide principal market and distribution Canada securities in USA are convinced that public offering and distribution of a Dominion *long term loan in amount sufficient to refund these issues can be made on terms at least equal if not more favourable to government than can a private placement restricted to a few investors."*[713]

Based on the limited documentation available, the following observations seem warranted on private placements. Firstly, the immediacy of the cash requirement tends to dictate a private placement to avoid S.E.C. filing requirements, legal opinions, meetings with the underwriters, advertising, etc. This was certainly the case in November and December 1947 when Canada's U.S. dollar reserves were dangerously low. Still, there was a considerable amount of time spent shopping around for the best deal. This is avoided during a public issue since once the time and price are established, the syndicate is responsible for ensuring that the bonds are absorbed. Secondly, a narrower distribution reduces the trading of these bonds in the secondary market which are usually held until maturity.[714] The lack of active bond trading will distort, to some extent, the price signals coming from secondary markets. Thirdly, a broad distribution of a security is always superior to a narrow distribution since the dumping of these securities on the market by a few large institutions may have a harmful effect on the sale or refunding of bonds and the credit standing of other Canadian borrowers. Finally, the direction of interest rates may hamper the chances of a longer term private issue as banks and life insurers are very sensitive to capital losses when rates fall and will use these face to face negotiations and the issuer's need for cash as leverage when bargaining over price and term.

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[713]Nevil Ford to G.F. Towers, 15 July 1949, *Bank of Canada Archives*, "DG-401-157, "U.S. Loan, 2 3/4% due 1974." (emphasis added),

[714]In February 1952 A.E. Ames arranged the sale of $25,000,000 of the bonds privately placed in August 1948.

Summary

Over the last two decades, many studies have been published which have purported to demonstrate the pernicious consequences of foreign *direct* investment on the Canadian economy.[715] However, these studies have ignored, in the main, the biggest source of foreign investment in this country– the vast sums borrowed each year by provincial governments, their agents, and private corporations in the form of debenture stock.[716] Between 1972 and 1982 foreign borrowing by provincial governments and their agents has represented a low of 10 per cent in 1980 to a high of nearly 50 per cent in 1976 of gross provincial borrowing. For municipalities these figures range from a low of 15 per cent in 1972 to over 50 per cent in 1976. This portfolio investment differs from "direct" investment in the sense that it does not represent "ownership", that is "control" of a company's or province's fortunes. This type of "indirect" investment has become uncritically accepted as more benign and as the route to go to finance the repatriation of Canadian companies, e.g. the National Energy Program. This view is mistaken for bonded indebtedness over a long period of time is contractually the *first claim* against the assets, revenues and taxation of a firm or a government. The shareholder/owner is always the last one to receive payment. Although bondholders legally may not participate in decision–making when a company or government is prospering, during periodic financial crises, bondholders' representatives may become intimately involved in strategic decisions involving key personnel, the issue of new equity, and the rescheduling of the debt, i.e. Dome Petroleum.[717] Now while governments rarely go bankrupt, they often find themselves short of cash and financially embarrassed leaving them vulnerable to the decision–making of bankers and other financiers. To–day it is taken for granted that the International Monetary Fund is acting legitimately when it orders subsidies to be cut in

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[715]Task Force on the Structure of Canadian Industry, *Foreign Ownership and the Structure of Canadian Industry: The Watkins Reprt*, (Ottawa: 1968), Eric Kierans, *Challenge of Confidence: Kierans on Canada*, (Toronto: 1967), Walter L. Gordon, *A Choice for Canada*, (Toronto: 1966), Kari Levitt, *Silent Surrender: The Multinational Corporation in Canada*, (Toronto: 1970), *Dual Loyalty: Direct Foreign Investment in Canada*, (Ottawa: 1972), and Wallace Clement, *The Canadian Corporate Elite*, (Toronto: 1975).

[716]According to the *Bank of Canada Review*, by 1978 Canada's bonded indebtedness totalled $53.8 billion while direct investment is $48.2 billion. In 1970 direct investment totalled $26 billion while portfolio investment totalled $18 billion. (Table A15, July 1983).

[717]It is hardly a coincidence that shortly after Moody's Investors Service made their annual pilgrimage to provincial capitals during the summer of 1982, the Quebec Government announced its reactionary plan to retroactively roll back public servants' wages to preserve the credit standing of the near–bankrupt province. Nor is the recent downgrading of B.C.'s credit rating and its attack on the public service entirely unrelated.

Mexico and the reduction of social services and civil service wages in Brazil. In these cases, the notion of national sovereignty has been clearly superseded by respect for contractual obligations. It is not only financial embarrassment that may lead to foreign creditors exerting undue influence on domestic financial and social policies but also the need to borrow or to refund maturities in those markets which forces the debtor to maintain good relations with foreign capital.

Did foreign borrowing then erode Canada's sovereignty? Or, to rephrase the question: Has Canada's independence been violated in any way as a result of its indebtedness to financial institutions and citizens of the U.S. and the U.K.? Certainly Canada's experience was markedly different with that of Latin American and Central American; nations whose custom houses were routinely seized in the first three decades of this century, it would seem that Canada's sovereignty was never in serious jeopardy.[718] For the most part, international capital regarded Clark, Towers, and Liberal and Conservative governments as capable and reliable. There is very little evidence to suggest that Canada's monetary and fiscal policies were determined abroad. The control exercised was more subtle and was based on the common language spoken by bankers and the set of expectations, assumptions and norms evolving from the officials and bankers socialization consisting of a common experience, shared perceptions and attitudes about the workings of capital markets. The market was the main experiential focus of socialization rewarding and discouraging certain types of behaviour. This common language and world view took for granted the sanctity of financial contract and the central role of capital markets. As one former Bank and Finance Department official observed: "you must listen to the market; if you don't, you'll be crucified."[719] A recognition that the market was seldom wrong and it was the most efficient mechanism for distributing financial wealth was firmly held by the key participants in this study. It is this ideological commitment to market norms which presented the main obstacle to a creative policy which could have used the state more effectively to redistribute wealth and income in a

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[718] Harold Groves cites one author who found that in 1925, "the United States exercised financial control over more "backward nations" than any other country. A common practice for governments with weak credit is to pledge a specific revenue source as security for a loan. Thus El Salvador refunded its national debt in 1923 and obtained credit in the United States by pledging as security 70 per cent of its customs receipts. Bolivia pledged the entire receipts of its customs to New York bankers in 1922." *Financing Government*, Fourth Edition, (New York: 1954), p. 543.
[719] *Interview*, 9 June 1982.

socially optimal manner.

Canada's substantial refunding of its direct and guaranteed debt abroad combined with its goal of low cost financing taught debt managers to listen to the market and to respect and understand what motivates price rises and price falls. Debt managers were taught through constant daily contact with markets what financial news and political behaviour would be tolerated and praised by the market. It was in this context that the thinking of Towers, Clark, and others evolved. Mackenzie King once recorded in his diary how he was struck by the thinking of Towers and the "Finance crowd" during deliberations on the low interest loan to England after the war. King noted on 18 February 1946 "I confess that Towers' statement did not impress me. What did impress me was that as the Governor of the Bank of Canada he was really under the influence of large financial banking world. It was clear he was influenced by their environment."[720]Several days later, King returned to the same theme, recording:

> Of course I feel that Clark and all his group and all the Finance Department and the Bank of Canada people, the big trade interests and so forth have only one point of view and really are a world of finance– feeling a greater common interest in finance than they do any interest in common with the political world.[721]

It would seem that King had learned through experience that the "money power" which he had attacked in 1935 for purely political reasons was truly a force to be reckoned with, wielding considerable influence on the positions taken in cabinet by his Minister of Finance as representative of these big business interests.

In the case of Alberta, the central bank acted resolutely in responding to the expectations of foreign bondholders by ensuring that default would be contained and Alberta' misbehaviour would not be rewarded through highly publicized subventions from the federal treasury. Towers was acutely aware of the market's negative reaction to "manifestations of good or bad faith" in the arena of government debentures *against which no specific assets are pledged.*[722] Knowing that knowledgable institutional investors

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[720]J.W. Pickersgill and D.F. Forster, *The Mackenzie King Record, Volume 3, 1945-1946,* (Toronto: 1970), p. 165.
[721]*Ibid*, p. 168.
[722]Towers Memoranda, No. 130, 5 May 1938, "Rowell Sirois Commission Submission," *Bank of Canada Archives*. This is very important for as discussed in the next chapter, Alberta bondholders had no legal remedy to get back the full amount of their interest payments in spite of court rulings on their behalf. The bondholders had no lien against any specific revenues.

faced with a variety of choices in bonds would rarely choose obligations unless the underlying security was sound, Towers sought to preserve the debtor-creditor relationship, the glue that binds capitalism together.

The testiness of international investors to a possible imposition of special withholding taxes reveals how very sensitive institutional investors were to reductions in the after-tax rate of return. This facet of investment behaviour leading to a heavy sell-off of the affected class of bonds was the most effective way that foreign capital could discipline the borrower. This leverage was most authoritative when large refunding and/or new market issues were being contemplated. The fate of the 1941 withholding tax proposal is perhaps the most concrete assault on domestic policy-making by foreign capital. Towers viewed this move as a form of repudiation and forged a tacit alliance with foreign capital and major domestic borrowers to scuttle this proposal.

In conclusion, while foreign capital did not dictate Canadian economic policies in any vulgar sense, it did influence profoundly the course of federal-provincial relations during the decade of the 1930s and during the war; in particular, the Loan Council idea and the tax rental scheme were designed to ensure that principal and interest would be met. This influence was transmitted through market contacts and made operational by the Dominion's ever present concerns about its credit standing in these markets. Secondary market trading abroad became the thermometer closely monitored by officials in Finance and the Bank of Canada. The Dominion's understandable desire for low cost financing thus gave foreign capital a lever to discipline the borrower when its policies were viewed as contrary to the interests of bondholders.

IX. DEBTOR VERSUS CREDITOR: THE ALBERTA ABERRATION

> The Province has the power to make it impossible for any bank to operate within its borders, to prevent it enforcing its claims for debt, to make the business of money-lending illegal and impossible, to publicise banking practice, and in many ways to inflict severe penalties upon the financial interests. I do not suggest that the financial interests in their turn have not the power to inflict damage upon Alberta but I do not believe that that power, if seriously challenged, is anything like so great as it is popularly supposed to be. Nor do I think that the condition of affairs in Alberta would be very much worse, except possibly for a very short time, if such very ill-advised action upon the part of the financial authorities were put to the test. The financial system is essentially a system of black magic and one of the best protections against black magic is not to believe in it.
>
> Major C.H. Douglas[723]

Moody's Investors Service, the information gathering organization for investors includes in its analysis the debt records of borrowing entities. The Government of Canada's debt record is clean: since Confederation there have been no defaults on principal or interest and all sinking fund provisions have been met in their entirety.[724] In contrast, Alberta was Canada's first and only province to default on a principal payment on April 1, 1936. Why did the Dominion, which prior to April 1936 had been so willing to advance moneys to provincial debtors to prevent default, refuse to guarantee Alberta's financial commitments? Why did the Dominion single out Alberta for special treatment while continuing to lend to Saskatchewan, Manitoba and British Columbia?

This chapter examines in some detail the unusual case of a default in which the interests of a governmental debtor and institutional creditors clashed. The coincidence of the financial embarrassment on the part of thousands of homesteaders and of the provincial government produced a series of legislative initiatives, begun by the U.F.A. but mainly instituted by Social Credit which drew a knife to the heart of finance capitalism. That is, the fixed contractual claims by creditors on government, retailers, homeowners, and farmers were vitiated in a crusade to restore purchasing power and the dignity of Albertans. The violation of public indebtedness was perhaps the most dangerous act for it symbolized the Government's resolve to alter the debtor – creditor relationship. This action taken by a government was more significant than private defaults because (1) the creditors had no legal claims against specific assets or revenues as was the case in private

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[723] *The Alberta Experiment: An Interim Survey*, (London: 1937), p. 95.
[724] *Municipal and Government Manual, 1982-83*, Volume II, (New York: 1983), p. 4489.

debts and (2) the Government, responsible for the administration of justice and the enforcement of the fixed claims of creditors, was walking away from its own obligations, an action which raised important ethical questions.

The analysis of this struggle will trace the background of the conflict by paying particular attention to the economic and financial factors precipitating, and in many minds, necessitating default. In the following sections, the measures introduced by the Province and the response of the chartered banks in the fields of credit creation, debt moratoria legislation and laws respecting banking are investigated. The final section considers the other mechanisms adopted by the banking system to defend their financial prerogatives.

Prelude to Default

Economic Backdrop

Before the halycon days of the Leduc oil discovery and the OPEC oil embargo, the economy of Alberta was heavily dependent on the production and marketing of grains. In 1929, nearly 40 per cent of provincial income was derived from the activities of the independent commodity producer and wage labour hired by the farmer.[725] Deflationary pressures which commenced on grain exchanges in 1929 reduced the average price per bushel of wheat from $1.14 in that year to a low of 32 cents for 1932.[726] The heavy reliance on grains, seeds, and hay for income resulted in a staggering drop in the farmers' standard of living and also had an equally devastating effect on the retailers who supplied the farmers and the provincial treasury which taxed farmers' incomes. As Table 9.1 illustrates, receipts were cut to one quarter the level of 1928 by 1933 even though total production was cut by one-third. While other agricultural sectors including livestock and fruit and vegetables also suffered heavy declines, these losses were not as extensive nor as consequential to this recently-settled, heavily indebted grain exporting region. Falling export prices combined with agricultural protectionism on the continent and the heavy devaluation of the Argentinian and Australian currencies left the western producer with greatly reduced marketing opportunities forcing the Conservative government into a band-aid programme of stock-piling wheat.[727]

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[725] D.C. MacGregor et al, 1939, Table IX, p. 55; Table IX-A, p. 89 and Table IX-C, p. 90.
[726] Government of the Province of Alberta, *The Case for Alberta*, Part I, (Edmonton: 1938), Table III, p. 16.
[727] Royal Commission on Dominion-Provincial Relations, *Report*, Book I, (Ottawa: 1940), pp.

The lack of markets, low prices, and high, fixed charges for transportation and debt service rendered wheat production virtually uneconomical by 1932. For 1932, Professor MacGregor's estimates reveal that of a total of $67 million in farm receipts, interest consumed one quarter of the farmers' estimated expenses of $68 million.[728] Debts contracted when wheat sold for $1.25 per bushel became financially impossible at 40 cents a bushel. On top on this difficulty, charges were made by farmers and substantiated by politicians and bankers, that the legal maximum rate of interest was frequently exceeded by the practice of discounting the farmers' promisory notes.[729] The cost of transportation and threshing charges which at one point constituted more than one half of the total value received by framers also cut into the farmers' net income.[730] And finally, the tariff which protected the manufacturing industries primarily located in central Canada, tended to reduce the downward movement of semi-processed and finished goods. The Rowell-Sirois study calculated that by 1931, the cost of tariff-protected manufactured goods to the wheat producer had doubled.[731]

TABLE 9.1
Alberta Farm Receipts, 1926-1937

YEAR	Grains, Seed, Hay	Vegetables, other field crops	Livestock	Dairy	Total*
1926	114.12	.66	34.87	6.31	160.81
1927	126.56	.59	29.93	5.91	168.50
1928	165.24	.70	32.83	6.32	210.60
1929	120.10	.73	36.08	6.84	169.20
1930	55.45	1.14	25.46	6.27	93.23
1931	42.64	.98	16.89	5.34	69.44
1932	46.97	1.10	11.77	3.88	66.96
1933	43.66	.97	13.84	4.43	65.99
1934	60.25	1.30	22.22	5.36	92.38
1934	58.83	1.09	27.35	5.25	96.06
1936	48.38	1.70	30.79	6.23	90.78
1937	66.29	1.91	36.21	7.65	116.47

SOURCE: D.C. MacGregor et al, *National Income*, A Study prepared for the Royal Commission on Dominion Provincial Relations, Appendix 4, (Ottawa: 1939), Table IX-E, p. 91. (in millions $Canadian)

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[727](cont'd) 144-145.
[728]MacGregor et al, 1939, Table IX-E, pp. 91-92.
[729]W.J. Loucks, House of Commons, *Debates*, 17th Parliament, 2nd Session, 23 March 1931, pp. 234-235, M.N. Campbell, House of Commons, *Debates*, 17th Parliament, 2nd Session, 25 March 1931, pp. 302-303. Testimony of Canadian Bankers' Association President J.A. McLeod, *Proceedings*, Royal Commission on Banking and Currency, Ottawa, 14 September 1933, pp. 3260-3263.
[730]Government of the Province of Alberta, 1938, Part I, pp. 196-197.
[731]Royal Commission on Dominion-Provincial Relations, *Report*, 1940, Book I, p. 159.

*– Includes other farm income, miscellaneous income.

In comparison with Saskatchewan and Manitoba's agricultural sector, Alberta was relatively well off except in the south–east corner of the Province which suffered the drought in the "Palliser Triangle".[732] Accordingly, Alberta's experience became politically and economically unique because its recent settlement, relative to the heavier populated neighbouring province of Saskatchewan left it with high debt charges which made the banker the villian when money became scarce. The crisis confronting the majority of Alberta farmers was not one of insufficient production and production yields but the burden of indebtedness contracted when wheat prices were buoyant. Unlike their brethren in Saskatchewan who were unable to produce for a depressed market for climatic reasons, the Alberta situation was perceived to be the product of an archaic financial system. Any attempt to explain the differences between the "political culture" of "free enterprise" Alberta and "socialist" Saskatchewan therefore must take into account Alberta's ability to produce and her heavy indebtedness which fostered the spread of underconsumptionist theories.[733] Although Saskatchewan farmers also paid nearly one fourth of their costs over to banks and loan companies[734], nevertheless Saskatchewan never experienced "poverty in the midst of plenty" in quite the same way that Alberta did.

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[732]Royal Commission on Dominion–Provincial Relations, *Report*, Book I, pp. 170–171.
[733]See especially Myron Johnson's essay "The Failure of the C.C.F. in Alberta: An Accident of History," in Carlo Calderola (ed.), *Society and Politics in Alberta, Research Papers*, (Toronto: 1979), pp. 87–107. Alberta and Saskatchewan certainly did share the experience of "income insecurity" stressed by S.M. Lipset in *Agrarian Socialism*. However each province experienced very different levels of production throughout the depression which obviously had a direct bearing on the form that agricultural protest would take. See Royal Commission on Dominion–Provincial Relations, *Report*, Book I, 1940, p. 170.
[734]MacGregor et al, 1939, Table VIII–E, p. 88.

TABLE 9.2

Provincial Income Western Canada, 1926-1937

YEAR	Manitoba	Sask.	Alberta	British Columbia	Canada
1926	289.8	402.5	302.1	335.9	4,080.7
1927	293.3	391.1	319.2	349.9	4,246.2
1928	311.6	452.3	381.7	377.1	4,641.1
1929	313.3	380.1	353.1	395.7	4,718.6
1930	270.3	231.8	254.2	363.8	4,678.6
1931	225.6	163.6	204.4	297.3	3525.0
1932	184.2	135.6	174.9	243.9	2,861.7
1933	170.1	125.6	158.9	223.2	2,632.3
1934	188.1	155.8	188.1	241.1	2,879.3
1935	192.4	176.1	207.2	264.2	3,116.5
1936	215.8	205.1	209.9	289.4	3,416.5
1937*	258.9	194.9	242.5	319.1	3,829.4

(In $millions Canadian)

SOURCE: D.C. MacGregor et al, *National Income*, A Study prepared for the Royal Commission on Dominion Provincial Relations, Appendix 4, Table X, pp. 53-56.
*1937- preliminary figures.

Alberta was not a homogeneous society of independent commodity producers as some observers seem to have suggested.[735] Table 9.3 confirms the central role of agriculture in Alberta but also shows the significance of mining, government and the investment sectors during the depths of the depression. This table also reveals the variability of agricultural incomes in marked contrast with government wages and salaries and investment returns. The downturn in wage labour, though not as great as in agricultural enterprises implies that wage labourers too might be receptive to the appeals of Social Credit. Those segments less vulnerable to the downturn included the professions, government and para-government employees which formed the nucleus of opposition to Social Credit.

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[735]See Larry Pratt and John Richard's critique of C.B. Macpherson in *Prairie Capitalism: Power and Influence in the New West*, (Toronto: 1979), pp. 149-153. This criticism seems unduly harsh inasmuch as the most salient characteristic of Alberta's class structure at the time was certainly the independent commodity producer. To argue strenuously for the political significance of coal miners and Calgary's *haute bourgeoisie* would tend to distort, rather than clarify, class relations. At this time, in the midst of a brutal deflation, labour-capital relations were subordinated, in political and economic terms, to the clash between debtor and creditor.

TABLE 9.3

Alberta Income, 1926-1937

YEAR	Agric. Labour	Net Agric. Income	Govt Wages Salaries	Mining Wages Salaries	Investment Income	Total Salaries*
1926	18.0	91.3	15.9	13.9	20.6	155.5
1927	21.5	91.9	17.6	15.1	21.5	168.6
1928	22.6	130.6	18.2	17.2	22.5	187.4
1929	17.9	91.9	19.2	19.0	23.6	194.2
1930	16.6	13.8	19.7	15.5	25.0	178.9
1931	12.8	(1.9)	19.4	10.9	24.1	152.2
1932	11.5	(1.1)	17.1	10.2	19.2	127.9
1933	9.5	2.9	15.8	9.3	16.2	111.8
1934	9.9	27.7	15.8	9.6	15.8	114.3
1935	12.4	28.6	16.4	10.6	16.6	124.2
1936	9.7	32.0	17.5	11.6	17.0	127.0

(In $millions Canadian)

SOURCE:D.C. Macgregor et al, *National Income*, A Study prepared for the Royal Commission on Dominion Provincial Relations, Table IX-A, p. 89, Table IX-B, p. 89 and Table IX-E, pp. 91-92.

* Excludes agricultural net income.

Public Finance

We would expect that a sharp drop in provincial income would lead to an equally sharp decline in government tax revenues. Table 9.4 reveals that revenues fell off substantially after 1929 but tax measures introduced in 1931-32 and in 1936 considerably raised the take of the provincial treasury. In 1929, taxes and other revenues amounted to only four per cent of provincial income; by 1933 revenues, though dipping by almost 15 per cent, consumed eight per cent of provincial income. As a result of the collapse of the agricultural sector, Alberta' s deficit widened in fiscal 1929 from a surplus of $100,000 to a deficit of $7.1 million in fiscal 1931. Prior to the official reduction of interest charges in June 1936, deficits over two million dollars were the order of the day which represented from one sixth to one half of budgeted expenditures.[736]

Causes of the Crisis in Public Finance

There are several related factors which account for the widening of the deficit. In the first instance, the Liberal government left a legacy of large, unproductive debts for the United Farmers of Alberta. According to the Bank of Canada's 1937 survey of the

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[736]Government of Alberta, Treasury Department, *Public Accounts of the Province of Alberta*, (Edmonton: 1928-1937).

Province's finances

> By the end of 1922, Alberta had direct and guaranteed debt (on which it was paying interest or for which it was later to become liable) which was some 50 per cent larger than in the much older province of Manitoba and more than twice as large as that of Saskatchewan though Saskatchewan had a 30 per cent larger population. Substantially more than half the Alberta total represented accumulated losses and deficits, or so-called assets which were proving a constant drain.[737]

Among those assets "proving a constant drain" were included $20,000,000 which had to be written off because the Province was unable to maintain its telephone system.[738] Another source of the acute financial embarrassment were guarantees provided to several railway and irrigation projects in Southern Alberta.[739] Thus, loose financial management, wildly over-optimistic capital expansion projects, and poor judgement left the Farmers' government with a heavy burden of debt on their hands when the took office.

The second principle source of Alberta's public indebtedness and revenue deficiency stemmed from the U.F.A. policy of not raising taxes to cover the growing demands for roads, schools, public works, and all the operational costs associated with these capital projects. Indeed, per capita taxes in 1929 were lower than the 1921 level although the total taxes collected were higher.[740] According to the central bank's analysis, "the province could scarcely have expected a more favourable opportunity than that presented in the years 1925-1929 to recoup itself from the rural areas for some of the large expenditures made on them. The opportunity was allowed to pass, and no reduction in the dead weight debt took place."[741]

When Depression struck the dead-weight nature of the unproductive debt involving fixed interest charges and an insufficient revenue base prompted a thorough examination of Alberta's provincial and municipal taxation system. The Alberta Taxation

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[737]*Report on the Financial Position of the Province of Alberta*, (Ottawa: April 7th 1937), p. 8.

[738]*Ibid*, p. 21. During 1936, numerous rumours abounded to the effect that a New York consortium of investors was interested in purchasing the run-down network. *The Calgary Herald*, "Admit Gov't Negotiating for Telephone Deal," 19 March 1936, p. 1.

[739]In *The Case for Alberta*, the Province argued that as these projects contributed significantly to the nation's economic life, the Dominion should be willing to absorb its costs. Part I, pp. 69-85.

[740]Bank of Canada, April 1937, p. 12 and Jacob Viner, August 1939, p. 45.

[741]*Ibid*. According to the Public Accounts Inquiry undertaken by the Royal Commission on Dominion-Provincial Relations, the small surpluses were more properly accounted for as deficits. Calculations made by the Government excluded interest paid on guaranteed debentures and debenture discount amortization. *Province of Alberta, Comparative Statistics of Public Finance, 1913, 1921, 1925 to 1937*, Appendix J, "Revised", Schedule 4, p. 9.

Inquiry Board appointed in December 1933, took evidence from business, labour, citizens groups, and manufacturers.[742] The principal conclusion of the inquiry was a recommendation to boost taxation to the level of other provinces.[743] This report along with the recommendations of R.J. Magor, "orthodox financier" and J.C. Thompson, Provincial Auditor, figured prominently in the production of the March 1936 budget which raised tax rates and imposed a two per cent retail sales tax.

TABLE 9.4

Provincial Government Revenues, 1926-1937

YEAR	Taxes	Permits, Licenses, Fees	Public Domain	Liquour Control	Gross Dominion Subsidies	Total*
1926	3,624.4	2,230.3	518.0	1,941.3	1,759.1	11,072.7
1927	4,519.1	3,516.2	264.3	2,767.0	2,246.1	14,563.6
1928	4,586.4	3,430.1	206.4	2,893.8	1,762.0	14,055.6
1929	5,518.3	3,244.9	166.1	2,586.4	1,747.8	14,489.1
1930	4,868.8	2,943.1	793.5	1,888.3	2,211.0	13,819.0
1931	3,950.9	2,448.4	988.0	1,423.5	4,762.1	11,698.8
1932	5,166.2	2,491.7	809.5	1,427.0	5,207.3	12,927.7
1933	4,909.1	2,561.8	971.7	1,251.0	4,131.0	12,609.1
1934	5,506.4	2,621.3	1,182.5	1,526.0	4,470.6	13,919.8
1935	5,919.1	2,361.6	1,165.2	1,843.6	4,775.8	14,323.4
1936	7,393.2	2,556.7	1,540.7	2,400.0	6,801.8	17,047.7
1937	8,680.7	2,830.0	1,686.3	2,590.0	6,990.4	18,895.0

(in $millions Canadian)

SOURCE: Royal Commission on Dominion-Provincial Relations, Public Accounts Inquiry, *Province of Alberta, Comparative Statistics of Public Finance, 1913, 1921, 1925 to 1937,* Appendix J, "Revised", (Ottawa: 1939), Schedule 7, p. 9.
* Total Revenue *excludes* Dominion subventions and grants in aid which was deducted from expenditure accounts for a net figure.
(Figures as at March 31 of succeeding year.)

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[742] *Report of the Alberta Taxation Board on Provincial and Municipal Taxation,* (Edmonton: 30 November 1935).
[743] *Ibid*, p. 146.

TABLE 9.5

Provincial Government Expenditures

YEAR	Net Debt Charges	Public Welfare	Education	General Gov't	Administration of Justice	Total*
1926	4,603.1	1,580.3	2,118.4	1,032.7	985.5	11,852.1
1927	5,871.1	2,179.9	2,991.2	1,340.0	1,246.7	15,495.1
1928	4,839.3	1,901.5	2,503.9	1,106.5	1,028.2	13,065.3
1929	4,639.2	2,526.0	2,707.6	1,214.7	1,097.6	14,388.9
1930	4,332.3	3,354.2	3,170.3	1,326.9	1,216.3	16,364.6
1931	6,377.1	4,109.7	2,661.0	1,433.7	1,131.9	18,846.2
1932	6,069.8	3,671.2	2,562.6	1,437.0	778.0	16,647.5
1933	6,027.3	4,019.2	2,437.7	1,364.4	734.8	16,429.3
1934	6,149.1	4,292.0	2,304.3	1,438.3	742.3	16,723.5
1935	6,112.4	4,501.0	2,468.6	1,510.8	723.8	17,151.1
1936	3,795.7	5,755.7	2,569.2	1,606.3	717.9	16,626.6
1937	3,558.6	5,346.8	2,637.2	1,690.4	760.4	16,359.9

(In $thousands Canadian)
SOURCE: *Province of Alberta, Comparative Statistics of Public Finance, 1913.1921, 1925 to 1937,* Schedule 8, p. 13.
* Includes *inter alia* Legislation, Highways, Bridges and Ferries, Agriculture, Public Domain. (As at March 31 of succeeding year.)

A third reason for the Government of Alberta's financial predicament was the heavy burden of relief charges especially in the cities of Edmonton and Calgary. As Table 9.5 shows, costs for relief and other forms of public assistance soared with the onset of Depression. Still, Alberta's per capita payments on relief were one-third less than the national average and a little over one-quarter of Saskatchewan's per capita payments.[744] Various efforts were made during the 1930s to reduce government costs including a 10 per cent cut in the salaries of civil servants and reduction in teachers' salaries.

Character of Alberta's Public Debt

By 1932, after racking up official deficits of $2.3 million and $5.3 million, the credit of the province was exhausted. The province was unable to borrow abroad and could only borrow in Canada from the Dominion or from domestic sources at punitive rates. Between January 1933 and the April 1, 1936 default the Province was able to borrow only $7.6 from domestic sources[745]

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744 Royal Commission on Dominion-Provincial Relations, *Report*, Book I, pp. 236-239.
745 A common complaint of the Alberta Government and other western governments was the lack of low-cost financing when banks were liquidating commercial loans and purchasing securities which were soon trading at a premium. In a presentation before the Macmillan Commisssion, R.G. Read, Provincial Treasurer requested "your Commission to note that during the period the Province was unable to sell debentures at a lower cost than 6.76 %, the banks were able to borrow under the Finance Act from the Dominion at 3 %."

while borrowing $26 million from Ottawa during the same period at rates between three and six per cent. This series of ad hoc, short-term treasury bill financings allowed the Province to avoid default by borrowing from the Dominion at one-half point above federal long-term rates but about 200 basis points higher than the prevailing treasury bill rates.

The most damaging aspect of the structure of Alberta's public debt was the existence of optional-payment bonds and the absence of call features (Table 9.6). Earlier itwas noted that the optional-payment bond was the perfect vehicle for the foreign exchange speculator since the holder carried no risk while the issuer's position could be seriously jeopardized if one currency fell in relation to another. This happened in the wake of England's flight from gold and the Canadian dollar, though trading at a premium in relation to the pound sterling, fell to a ten to twenty per cent discount in New York. As a result, between March 1932 and March 1934, nearly $2 million was expended on unanticipated, extraordinary charges associated with the payment of interest and principal to holders in U.S. funds. Had a larger proportion of these optional payment bonds been "London or Canada", this unexpected levy would not have been as onerous on Alberta. It was not surprising therefore for the Provincial Treasurer to request a fixed exchange rate and a return to the gold standard as a remedy for the problems associated with exchange rate fluctuations.[746] It should be remembered that these bonds were issued at a time when fixed exchange rates under the gold standard was the rule of thumb and there was no apparent reason to believe that dramatic shifts in currency alignments would occur.

A second problem associated with Alberta's large per capita debt was the absence of call features. A call feature permits the borrower after a certain date specified in the contract, to call the bonds in for redemption. Normally, the issuer will sell new bonds at lower rates, retire the higher coupon stock and in the process realize substantial savings. Of the three series of debentures subject to a call provision, one was callable in 1949 and another in 1962. A third issue of $7,400,000 payable in sterling was callable at any time but at a large premium to be paid the holder making the provision useless until rates dropped to very low levels. For all intents and purposes then, Alberta's debt could not be called and this inflexibility made the bondholders most unwilling to re-negotiate and to

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[745](cont'd)"Submission to Macmillan Commission," 21 August 1933, p. 4.
[746]*Ibid*, pp. 6-7. One of the Rowell-Sirois recommendations never acted upon was a Dominion subsidy to make up for provincial exchange losses.Royal Commission on Dominion-Provincial Relations, *Report*, Book II, pp. 123-124.

return their relatively high yielding stock in exchange for lower yielding securities without any premium paid.

TABLE 9.6

Province of Alberta Public Debt as at March 31, 1936

Classification	Amount ($thousands $Cdn.)	% of Total
Total Outstanding	$160,831.0	100.0
Direct Issues	154,016.5	95.8
Guaranteed Issues	6,814.5	4.2
Treasury Bills Outstanding	25,427.0	15.8
T-bills held by Dominion	25,218.0	15.7
Amount of debt callable	15,267.0	9.4
Tax Free	134,149.5	83.4
Payable in:		
Canada	55,804.0	34.7
Canada or New York	65,843.0	40.9
Canada, New York or London	19,915.0	12.4
Canada or London	4,000.0	2.5
London	15,269.0	9.5
Coupon Rates		
4%	33,331.0	20.7
4.5	51,756.0	32.2
5.0	45,773.0	28.5
5.5	8,632.0	5.4
6.0	20,890.0	13.0
6.5	450.0	0.3
Maturing in:		
2-5 years	750.0	0.6
5-12 years	1,650.0	1.3
over 12 years (excluding treasury bills)	125,599.0	98.1

SOURCE: *Province of Alberta, Comparative Statistics of Public Finance, 1913,1921, 1925 to 1937*, Schedule 10,11,13,14.

Another factor which made the default situation more complicated was the debt's international character. Default of Canadian-pay debts was one thing, but default to foreign holders of the optional-pay instruments would, Towers claimed, lead to a general distrust of Canadian obligations. As Table 9.7 shows the Province was unable to substantially lower the average rate of interest on its debt because of these structural problems. The Dominion as noted in Chapter V, was able to lower its average interest rate by 85 basis points between 1930 and 1935 whereas Alberta's fell by only 10 basis points.

TABLE 9.7

Province of Alberta Public Debt, 1926-1937

YEAR	Gross Bonded Debt (1)	Average Coupon Rate (%) (2)	Gross Debt Charges (3)	Interest Receipts (4)	% Payable in Canada (5)	% Payable Abroad (6)
1926	111,252	5.17	6,498	1,895	17.8	82.2
1927	114,984	5.09	8,331	2,460	18.4	81.6
1928	120,616	5.03	6,940	2,101	17.5	82.5
1929	114,152	5.09	6,986	2,347	18.5	81.5
1930	124,065	5.04	7,185	2,853	17.0	83.0
1931	143,984	4.95	8,596	2,219	22.1	77.9
1932	147,824	4.96	8,980	2,910	21.5	78.5
1933	147,865	4.96	9,027	3,000	26.3	73.7
1934	153,312	4.96	8,724	2,575	31.5	68.5
1935	160,831	4.94	8,879	2,767	34.7	65.3
1936	161,700	4.94	5,964	2,168	35.0	65.0
1937	161,827	4.94	5,300	1,742	35.1	64.9

($thousands Canadian)
SOURCES:*Province of Alberta, Comparative Statistics of Public Finance, 1913, 1921, 1925 to 1937*, Appendix J.
Columns 1,2, Schedule 10, p. 17; Column 3, Schedule 9, p. 15; Column 4, Schedule 9, p. 16; Columns 5,6 Schedule 10, p. 17.

The foregoing difficulties associated with the *form* of the debt resulted in a deepening crisis for Alberta's treasury. The extent of this crisis can be gauged from correspondence in the months leading up to the August 22, 1935 Alberta election between Towers, J.F. Percival, and George Hoadley, Minister of Railways and Telephones. At the end of March 1935, Percival tested out the waters to see if the Bank would be willing to advance a loan to prevent default on an April first maturity, *payable in U.S. funds.* In a revealing letter to Thomas Bradshaw, Toronto financier and a member of the Bank's Executive Committee, Towers mooted the idea of becoming the Province's financial advisor.

> Profits, of course, do not enter into it, and there would therefore be no object in our treating this as an isolated transaction to help Alberta over their present difficulty. From that point of view it would be better to leave them in the hands of the Dominion Government. *If, however, we assume that it is possible to make general arrangements with them whereby we would become their financial advisors, with the authority to speak on budgetary matters and general financial policy, including the time and terms of public issues the matter deserves careful study.* Clark feels that if we can approve the risk we should not overlook an opportunity to start the ball rolling by consummating an arrangement of this kind. Alberta's financial position is not good, but they have made serious efforts to do their best. *As you know, the Province may now be considered one of the strongholds of monetary cranks, and some offsetting influence is highly desirable.*[747]

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[747] G.F. Towers to Thomas Bradshaw, 15 March 1935, "PF2– Provincial Government

In exchange for providing advice to Alberta from Towers, (Canada's "Prime Minister *ex officio"*, according to Major Douglas), Alberta was to become the initial proving grounds for what was essentially a loan council coordinating provincial debt management and budgetary policies. Moreover, Towers foresaw a "partnership" of the province, the provincial government's chartered banker,(Imperial Bank of Canada) and the Dominion. In such an arrangement, it is difficult to imagine that the provincial debtor would be treated as anything more than a juniour partner.

While Clark and Towers' designs over provincial finance were halted by the *Bank of Canada Amendment Act, 1936* which effectively prevented the Bank from acting in the capacity of financial advisor to a provincial government, Ottawa continued to subsidize the provinces. The Governor stillplayed a pivotal role as credit counsellor to provincial governments before and after the "nationalization" of the central bank. [748]

In June 1935, George Hoadley the Minister of Trade and Industry called Towers outlining his province's frustrations in attempting to raise $2,000,000 for an election road-building programme. "In stressing the Province's need for the additional money," wrote Towers later, "Mr. Headley (sic) said that if they had to confess their inability to proceed with the road programme, Aberhart's campaign would be greatly assisted."[749] It appaered the Bank of Montreal and the Royal Bank of Canada would no longer lend to the Province, at least on the terms the government desired. The Alberta's Government's banker, the Imperial Bank of Canada was prepared to advance $2,000,000 if the Province was willing "to hypothecate the amount due the Province by Canadian Pacific and Canadian National Railways"- approximately $5,500,000 payable in 1939. This hypothecation would also cover existing "IBC" advances to the Province of $4.2 million.[750] Later that

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[747](cont'd)Financing- Alberta, 1935, 1936,." *Bank of Canada Archives.* (emphasis added)
[748]J.F. Percival to G.F. Towers, 5 April 1935, *Bank of Canada Archives*, "PF2- Provincial Financing-Alberta, 1935, 1936," in which Percival expressed doubts about the province's capacity to withstand a run on provincial savings certificates and the rise of social credit. J.F. "Frank" Percival served as Deputy Provincial Treasurer from August 1932 until his retirement in 1949. Percival was, prior to his appointment, the Manager of the Edmonton Branch of the Imperial Bank of Canada- the government's banker.
[749]Towers Memoranda, No. 10, 5 June 1935, "Conversation with Honourable George Headley (sic), Minister of Trade and Industry, and of Railways and Telephones, Alberta, 4 June 1935," p. 2, *Bank of Canada Archives.*
[750]*Ibid.*

afternoon, Towers advised the Minister against accepting the bank's terms.

> It had not been the practice in Canada for Provinces or the Dominion to pledge specific assets as security for borrowings and in this case it might be thought that one creditor was obtaining an unfair advantage in view of the fact that the security represented a value of at least $3,500,000 in excess of the new money being obtained; and this excess would be applied as security for existing indebtedness. I suggested that he should obtain Mr. Bennett's opinion in view of the fact that the Dominion Government is an important creditor and may be called upon for additional assistance.[751]

However, this time the Dominion did not come to the rescue but the Imperial Bank did, but at a price. Despite the advance of approximately $1.5 million for road-building the U.F.A. government was routed and failed to elect even one member. It appeared that the lure of $25 per month "basic dividend" promised by "William Aberhart, B.A.," had won the day. "Alberta," *The Monetary Times* cynically noted, "votes for Santa Claus."[752]

Countdown to Default

Neither Aberhart nor Santa Claus anticipated that the provincial treasury was so empty that the regular civil service payroll was imperilled. A temporary loan from the Dominion for $2.2 million was arranged with the Bennett government. One active observer of these events, A.J. Hooke, has claimed that conditions were attached to the Bennett loan *viz.* that Robert Magor, a financial advisor and formerly the "trustee in bankruptcy" of the "Dominion of Newfoundland" be appointed Alberta's financial advisor.[753] However, another participant closer to these negotiations denied there ever having been an understanding between Bennett and Premier Aberhart on this matter.[754] From the Government's standpoint, the hiring of Magor and requesting funds from the Dominion was necessary in order to meet the payroll and to avoid the possibility of losing its credibility.[755] Moreover, Aberhart and his colleagues believed that the issue of straightening out the public finances, of balancing the books so to speak, was a completely separate question from establishing the basic dividend and that Douglas need not be offended by

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[751] *Ibid.* Interestingly, it was not until February 1936 that disclosure of this hypothecation to the Imperial Bank was made public. *The Calgary Herald*, "Government Reveals Loans from Chartered Banks Amount to $5,700,000," 12 February 1936, p. 3.
[752] 31 August 1935, p. 6.
[753] Hooke, 1981, p. 40.
[754] *Interview*, 13 July 1983. Magor's appointment had the effect of alienating Major C.H. Douglas who had been appointed the Government's advisor by the previous government and who resented Magor whom he saw as a nominee of the Montreal banks. Douglas, 1937, pp. 151–161. It is quite probable that Douglas used the Magor issue as a way of getting out of a situation in which he risked his reputation in a scheme which would, in all probability, be defeated by the Dominion and the federally regulated banking industry.
[755] *Interview*, 12 July, 1983 and *Interview*, 13 July 1983.

the presence of Magor.[756]

While the correspondence between Premier Aberhart and Major Douglas topped the news in January and February 1936, the Provincial treasurers were meeting in Ottawa to give initial approval to an amendment to the B.N.A. Act creating a Loan Council.[757] The day following this historic agreement, Charles Dunning announced the provision of a $2,000,000 loan to the Government of Alberta in order to meet maturities. According to press reports "no strings were attached", nevertheless as events,transpired strings were indeed attached.[758]

Less than one month later, controversy erupted over publication of a letter from Major Douglas condemning the Loan Council proposal which would "filch away" the Province's autonomy and which predicted that Alberta would break away from the stranglehold of "orthodox finance."[759] As the due date of April first drew closer for the repayment of a $3,200,00 Canadian denominated loan, it was learned that the prospect for further Dominion aid was in fact conditional on Alberta's acceptance of the proposal.[760] Ten days after this disclosure, rumours abounded that the Government was about to legislate a compulsory refunding scheme "with teeth in it."[761] This rumour led Charles Dunning to remind his provincial counterpart that much damage had already been done to prices of Western bonds from the March 15th announcement of a three per cent refunding scheme. The Finance Minister stated that on account of this proposal, he could not justify to Parliament and to the people of Canada the granting of another loan.[762] On April 1, 1936 the Province of Alberta became the first and only provincial government in Canada's history to default on the principal of a maturing obligation.

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[756]Indeed, this move was consistent with one of the Social Credit electoral pledges to make government more efficient and to eliminate the enormous waste of taxpayers' money. See Alf Hooke, *30 + 5: I Know, I Was There*, (Edmonton: 1970, pp. 66-69.
[757] *The Calgary Herald*, "Provinces Agree on Approval of Loans in Future," 14 January 1936, p. 1.
[758] *The Calgary Herald*, "Dominion to Aid Alberta to Meet Bonds," 15 January 1936, p. 1.
[759] *The Calgary Herald*, "Douglas Asserts Finance Threatens Canada's Democracy," 10 February 1936, p. 2.
[760] *The Calgary Herald*, "Must Accept Loan Council to Get Help- Dominion Guarantees to be Withheld from Opposing Provinces," 4 March 1936, p. 1.
[761] *The Calgary Herald*, "Compulsory Refunding Likely," 13 March 1936, p. 1.
[762]Hon. Charles Dunning to Charles Cockcroft, 17 March 1936. Tabled in House of Commons, *Debates*, 18th Parliament, 1st Session, 1 April 1936, p. 1684. The complete correspondence is found on pages 1683-1687 of *Hansard*. See also Mallory's commentary, 1976, pp. 126-134.

Bond Price Movements

Let us digress for a moment to examine the effect of these public declarations on the price for Alberta bonds traded in the secondary market. In July 1935, the 4 1/2s of 1956 were trading at 94 bid and 96 asked. This compared favourably with the Saskatchewan 4s of 1960 trading at 89.50 bid and 92 asked. A week before the August 22nd election, prices were firmer with a bid of 97 and an asking price of 98.50. Evidently then, no discounting had been taking place. On the even of the election, some uncertainty crept in and prices fell by one and a half points. The day after the election, bond prices fell another two to two and a half points and deteriorating to a point where no trading was taking place. By early September the bid price stood at 88 down nearly 10 points from the eve of the election in spite of a general "firming" in the bond market.

During the remainder of the year and into the new year, prices fluctuated between 85 and 90 for the 4 1/2s of 1956. After Dunning's announcement in mid-January authorizing a loan to Alberta prices rose from 84-89 to 89 bid and 93 asked. Yet the extent of discounting on Alberta bonds is revealed when comparing this price on January 22nd with a price of 110.75 bid for C.N.R. guaranteed , 4s of 1956. While a premium would be paid for bonds guaranteed by the Dominion, this differential was indeed very large, the normal differential being 5 to 10 points. Prices remained in the low nineties during March until the final week of the month when few bids were received for Alberta bonds. After default occurred, the 5s of 1955 dropped by 8 points. After the Cabinet proclaimed a reduction of rates on May 30, 1936, prices dropped still further and by mid-August, the 4 1/2s of 1956, which had been trading around 90, were selling at 62 bid, 68 asked. These price declines were the direct result of political action taken to ostensibly restore the Province's financial position and occurred at a time when bond prices generally were rising.

Rationale for Default

As Professor Mallory has noted, this about face on the position of the Alberta Government towards the Loan Council left Treasurer Cockcroft in an embarrassing position.[763] Why had Cockcroft's commitment to the Loan Council been torpedoed? In all probability, the major factor which determined this about face was the incongruity in the

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[763]Mallory, 1976, pp. 130-131.

world's first Social Credit government surrendering control over a key element of its financial affairs to a central bank and the senior level of government. Given the deep-seated, agrarian suspicion of the "fifty big shots", of corrupt eastern politicians and hostility to the money power, such submission to financial tutelage would have raised a storm of protest inside the party and the caucus. Secondly, as the Province claimed, it simply could not meet its principal payment– it did not want to default but it would not submit to Ottawa's crass ultimatums. Third, default corresponded with the need to refund the debt at much lower rates. In Aberhart's mind, the orthodox proposals of Ottawa meant going further and further into debt without any visible benefits accruing to the debtor publiceople. The arbitrary reduction of interest was a way of living within one means and was also consistent with Aberhart's speeches concerning the evils of usury and the money-lenders occupying the temples on St. James Street and Bay Street. Finally, default was premised on the basis of the unusual doctrine (in the eyes of Finance at least) that sacrifices should be borne equally. The austere budget brought in on March 1, 1936 raising taxes demonstrated the Government's commitment to balancing its budget. However, these measures at a time of depression would have to be matched by sacrifices of bondholders.[764]. In the following sections the attempts of the Social Credit Government to scale down private indebtedness and the banks' efforts to resist these assualts on their Alberta operations shall be sketched.

Conflict over Credit Creation

According to Social Credit theory, the private monopoly of money was primarily responsible for the deficiency of purchasing power. This monopoly would make money scarce when it suited its purposes and make money abundant when it chose to do so. In order to restore prosperity, it was imperative that the elected representatives of the people wrestle this privilege away from the money power. To the Social Crediter, the availability of currency and credit should be based on the total production of goods and services in the economy and not on the amount of gold stored in the vaults of commercial banks or central banks.

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[764]C.B.A. Confidential Letter, A.W. Rogers to H.F. Patterson, Enclosure: "Report of 17 June 1936 Bondholders Committee and Government," *The Bank of Nova Scotia Archives*, Secretary's Department Papers 1, File 153.

Prosperity Certificates

The morning following the August general election, many Calgarians were seen lining up outside City Hall in anticipation of their receiving the first installment of the promised $25 basic dividend! The dividend was designed to rectify the chronic shortage of purchasing power– purchasing power which had been choked off by the money power.

The first step taken towards the creation of additional credit was an attempt to enlist the co-operation of retailers and wholesalers. In March 1936, Ernest Manning, Aberhart's trusted lieutenant and Minister of Trade and Industry introduced *The Social Credit Measures Act.* The Act empowered the Cabinet

> to put into operation any measures designed to facilitate the exchange of goods and services or any proposal which is calculated to bring about the equation of consumption to production and thus ensure to the people of the Province the full benefit of the increment arising from their association.[765]

The legislation gave the Government sweeping powers to investigate the prevailing circumstances and conditions of trade, industry and commercial associations.[766]

Another measure proposed the issue of special business licenses and the registration of workers.[767] The institution of a so-called "master code" purportedly was designed to eliminate price gouging and to pave the way for a "just price". Immediately after this measure became known, the opposition of retailers crystallized into the formation of a "Consumers League of Alberta." The League quickly placed ads in newspapers warning Albertans "to strike while the iron is hot;" to defeat the price codes at the very start. "Do you want your liberty? Do you want to be Hitlerized with your eyes wide open?" queried the League.[768] This early flurry of proposed legislation did much to unnerve the local business community and set the tone of distrust which characterized business-government relations and probably prejudiced many retailers against the subsequent stamp scrip programme.

In late April, plans were leaked respecting a scrip programme to finance the summer road-building programme.[769] The scheme, the brainchild of Lucien Maynard,

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[765] 1 Edward VII (Second Session), Statutes of Alberta, 1936, Chapter 5, Section 7.
[766] *Ibid*, Section 4.
[767] See *The Calgary Herald*, "New Measures Pave Way for Adoption of Master Code," 10 March 1936, p. 1.
[768] Placed in *The Calgary Herald*, 14 March 1936, p. 2.
[769] *The Calgary Herald*, "Scrip Wage Reported as Gov't Plan," 23 April 1936, p. 1.

Minister without Portfolio, was modelled along the lines used by some North American cities.[770] A certificate was issued to a road labourer in one dollar denominations and would act as cash in any economic transaction. Each Friday, the holder was required to purchase a one cent stamp to be affixed on the back of the certificate. The "bond" was non-negotiable without the stamps, there being room for 104 stamps representing a circulation life of two years. Stamps were usually sold through a local druggist, retailer, etc. who earned a small commission, remitting the receipts to the Provincial Treasury which maintained a separate account for the scrip. The Alberta scrip was a *depreciating* type of currency with a lifetime of two years and the requirement that the proper number of stamps affixed. The function of the stamp revenue enabled the government to redeem these bonds when presented out of a special redemption fund every second Wednesday, Thursday, and Friday.

Objectives

The objectives of the plan were basically threefold. Firstly, the scrip would alleviate some of the financial strain on the treasury for public works, especially road-building. Discussions were also held with the major municipalities in the province to pay part of the relief costs through the issuance of scrip. Secondly, the authors of this legislation believed that by adding to the flow of purchasing power, the prospect of increased trade and confidence would emerge. And finally, the wide acceptance of these certificates and increased purchasing power would serve an educational function demonstrating to the public that use of the people's credit could begin to restore economic well-being.

Results

Even though the certificates were not issued until early August, (a month before *The Prosperity Certificates Act* was given royal assent[771]), the business community and the anti-government newspapers had opposed the scheme. In early July, Alberta wholesalers announced they would not accept the scrip and an organization was set up to distribute placards throughout the Province stating why "Scrip Not Acceptable."[772] Newspaper readers in Calgary were also informed of the failure of the City of Portland's scrip scheme

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[770]See V.F. Coe, 1937, pp. 67–68 and Hugh Whalen, 1952, pp. 503–508.

[771] Relevant Orders in Council were O-C 815/36, 11 June 1936 and 1085/36 of 27 July 1936.

[772] *The Calgary Herald*, "Cards Say Scrip Not Acceptable," 3 July 1936, p. 16.

and stressed the municipalities generally negative reaction to Maynard's proposal. The Government's decision not to allow acceptance of the scrip in liquor stores and the M.L.A.s unwillingness to take on more scrip for their sessional indemnity also tended to discredit the scheme. The chartered banks predictably refused to accept scrip on the grounds that they could not co-operate in this surrogate legal tender operation.[773] The legal complications were emphasized by the Nova Scotia's General Manager H.F. Patterson.

> while we think it would be mistaken policy on the part of the banks not to co-operate with the Government of Alberta in a general way in carrying out their plans, provided the interests of the banks are not prejudiced in the process, our view is that since the proposed "Prosperity Bonds" are not legal tender, the banks are under no obligation to accept them unless some provision is made by the Government to redeem them in legal tender......... Apart from that aspect, the requirement to affix tax stamps of 1% per week with no provision for immediate redemption, as far as we are aware, and with no assurance of their being accepted freely by the public, renders the bonds quite unacceptable and unsuitable for banking purposes.[774]

Patterson then went on to argue for resolution in dealing head-on with Alberta should the Alberta Government press the matter further. This view was apparently shared by the other chartered banks and in early July the banks announced publicly their decision not to co-operate. No court proceedings were instituted.

Operations of the Scheme

Originally $500,000 in scrip was printed and about $300,000 issued, well below the $2,000,000 authorized by statute.[775] Many retailers in the smaller centres and some in the larger cities readily accepted the scrip because these "Aberhart Bills" were better than receiving no payment at all. In Edmonton, the Chamber of Commerce attempted to have the plan stopped by a court injunction and some lawyers reportedly refused payment in scrip. Soon after its introduction, nearly 60 per cent of the scrip had been redeemed and by March 31, 1937, only $30,000 remained outstanding against which $25,000 stood available to redeem the dated scrip.[776] By early September, the programme was for all intents and purposes dead and the scrip quickly became an object for curio collectors–

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[773]C.B.A. Circular 158–H, 19 June 1936, "Alberta 'Prosperity Certificates'," *The Bank of Nova Scotia Archives*, Secretary's Department Papers 1, File 153.

[774] H.F. Patterson to A.W. Rogers, Secretary, Canadian Bankers' Association, 17 June 1936, *The Bank of Nova Scotia Archives*, Secretary's Department Papers 1, File 153. Legal tender fell exclusively under the jurisdiction of the Dominion. Sub–head 91(20).

[775]*The Prosperity Certificates Act*, 1 Edward VIII, (Second Session), Statutes of Alberta, 1936, Chapter 4, Section 4.

[776]Coe, 1937, pp. 81–86 and Treasury Department, *Public Accounts of Alberta*, 1937, (Edmonton: 1937).

hardly an experiment which could be considered an educational or economic success. However, it did net the provincial treasury about $32,000, the result of collectors retaining the unusual dated stamp scrip.

Moratoria Legislation

Provincial Initiatives

During the August 1936 session in which the issue of prosperity certificates were authorized, the Legislature passed *The Reduction and Settlement of Debts Act.*[777] The Act was motivated by the perceived arrogance and intransigence of lenders and their refusal to reschedule debts originally contracted when commodity prices were high. The Act, which was declared *ultra vires* the following June, caused *The Monetary Times* to thunder:

> At the recent session of the legislature, however, which met on August 25 and prorogued on September 1, it was evident that he (Premier Aberhart) had lost control, and that the back benchers in the party under the leadership of Honourable Lucien Maynard were pushing him into measures which not only strike at the very roots of credit and monetary security, but seem to be heading towards the establishment of a Soviet government in the prairie province.... The extremists were in the saddle and from the direction in which their achievements last week showed them to be riding, they are headed for something akin to Sovietism, if not the genuine article.[778]

The Act reduced all debts incurred prior to July 1, 1932 by applying all *interest* payments after that date to the reduction of principal. Another unusual feature of the Act was the inclusion of Section 16 which read "the provisions of this Act shall not be construed as to authorize the doing of any act or thing which is not within the legislative competence of the Legislative Assembly." This disclaimer did not make the act immune from the courts which held that this section could not stop the judiciary from ruling on the constitutional validity of the act. At about the same time, Saskatchewan's Liberal Government introduced sweeping debt reduction legislation which limited maximum interest chargeable on all farm

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[777] 1 Edward VIII (Second Session), Statutes of Alberta, 1936, Chapter 2.
[778] "Ottawa Should Disallow Legislation," 12 September 1936, p. 6. This analysis, by no means unusual for the "eastern" financial press is similar to an earlier declaration by this financial weekly which labelled Hepburn, Aberhart and Gerry McGeer as the "three musketeers". "It is customary," intoned The Times, "to look askance at the action of Mr. Hitler in breaking certain treaties and to offer thanks that we are not as others are or even as this Nazi, but when one looks at our own "kid forward line" of McGeer, Aberhart and Hepburn, we must realize that we as Canadians have not got much to brag about in comparison with Mr. Hitler after all, and that instead of putting one in the penalty box we ought to put four."! "The Business Outlook," 21 March 1936, p. 1.

mortgages to six per cent (clearly *ultra vires*) and wiped out all interest arrears to January 1935.

Complementing this action was a new Debt Adjustment Act which replaced an earlier U.F.A. statute enacted in 1922. *The Debt Adjustment Act, 1936* constituted a Debt Adjustment Board with responsibility to hear and settle disputes between debtors and creditors.[779] Sub-section 8(6) of the Act purported to vest the Board with ultimate powers of decision allowing no appeals from its decisions to the courts. In February 1937, both these acts were successfully challenged with Mr. Justice Ewing of the Supreme Court of Alberta ruling the legislation *ultra vires* on the grounds that the acts encroached upon the Dominion's jurisdiction over interest. Curiously, this judgment appeared to neglect a quarter century of Judicial Committee jurisprudence which had developed a rather liberal interpretation of property and civil rights. During the same session, legislation was also passed which cut all interest paid by the province and its municipalities by one-half validating an earlier order-in-council which had arbitrarily reduced interest payments.[780]

Bankers' Reaction

Although the banks' total holdings of Alberta Government paper, including bank pension funds, was very small (about $3.4 million or 0.1 per cent of all assets), legal opinions sought by the C.B.A. recommended a legal challenge. W.N. Tilley of Tilley, Thomson and Paramenter of Toronto believed the courts would not allow the abrogation of valid contracts in the guise of interest reduction on municipal debts.[781] As far as the bankers were concerned, the Municipal Securities Interest Act would inflict serious harm on the municipalities' borrowing ability since "there is no means whereby lenders can be forced to extend new credit where the interest rate is inadequate."[782] The withholding of credit therefore was seen as a legitimate way of retaliation to defend the banks' financial interests.

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[779] 1 Edward VII (Second Session), Statutes of Alberta, 1936, Chapter 3.
[780] *The Provincial Securities Interest Act*, 1 Edward VIII (Second Session), Statutes of Alberta, 1936, Chapter 11, *The Municipal Securities Interest Act*, 1 Edward VIII (Second Session), Statutes of Alberta, 1936, Chapter 12 and O.C. 734/36 30 May 1936.
[781] C.B.A. Circular 162-F, 17 September 1936, Enclosure: Copy of Opinion dated 16 Sept. 1936 by W.N. Tilley, Esq., K.C. re. The Municipal Securities Interest Act (Alberta)," *The Bank of Nova Scotia Archives*, Secretary's Department Papers 1, File 153.
[782] C.B.A. Circular 161-H, A.W. Rogers to the General Manager, The Bank of Nova Scotia, dated 3 September 1936, Enclosure: "Draft Brief, Alberta Legislation Restricting Interest on Municipal Securities to 3 %." p. 2, *The Bank of Nova Scotia Archives*, Secretary's Department Papers 1, File 153.

As far as the Reduction and Settlement of Debts Act was concerned, this too was regarded as unconstitutional. Opined the King's Counsel Tilley:

> A Provincial Act cannot authorize anything to be done which is not within the competence of the Legislative Assembly. The proper construction of an Act is for the courts and the question the courts must decide is not whether it professes to authorize something to be done not within the competence of the Legislature.[783]

In Tilley's view, this Act was also beyond the competence of the provincial legislative assembly.

Given these firm opinions on the validity of the legislation, what should the banks do? They could sit tight and let other vested interests challenge the legislation, petition the Dominion for disallowance or challenge the matter in a specific case. Tilley believed that another route would be best– reference to the Supreme Court of Canada for a quick decision which would avoid accusations of heavy–handedness that might raise Aberhart's standing with the Alberta voters. However, from a strategic point of view, Tilley thought

> the main application to the Government should be for disallowance and that it should be pressed strongly. If it is acceded to, the result will not be unsatisfactory. If it is not, the Government would be more apt to refer the matter to the Courts as a concession. *But I think nothing should be done to indicate to the Government that any other view is entertained than disallowance and reference should only be suggested as an alternative.*[784]

This evaluation was not shared by H.R. Milner, a prominent Edmonton lawyer and businessman who felt that disallowance would be playing into Aberhart's hands. As there was no organized demand for federal intervention into the debt settlement area, it was better to let the legislation be challenged in the courts.[785] Milner added the warning

> The Federal Government by now should realize that it is being, or soon will be, faced with a national emergency brought on by Aberhart's efforts to encroach on the Federal jurisdiction. *What he does today may very well subsequently be done by other provinces.* The failure of the Federal Government to disallow the Ontario Hydro Contract legislation will present the chief obstacle to

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[783]C.B.A. Circular 162–A, 16 September 1936, Enclosure: Opinion of W.N. Tilley, K.C. re. Debt Adjustment Act, *The Bank of Nova Scotia Archives*, Secretary's Department Papers 1, File 153.

[784]C.B.A. Circular No. 162–J, A.W. Rogers, Secretary to the General Manager, The Bank of Nova Scotia, dtaed 17 September 1936. Enclosure: Opinion of Mr. W.N. Tilley K.C. dated 17 September 1936, "Alberta Legislation. The Reduction and Settlement of Debts Act. Memorandum as to Disallownance, etc.," *The Bank of Nova Scotia Archives*, Secretary's Department Papers 1, File 153.

[785] C.B.A. Confidential Letter A.W. Rogers, Secretary to the General Manager, The Bank of Nova Scotia dated 28 September 1936. Enclosure : Memorandum dated Sept. 18, 1936, prepared by H.R. Milner, K.C.", p. 1, *The Bank of Nova Scotia Archives*, Secretary's Department Papers 1, File 153.

disallowance in Alberta.[786]

The C.B.A. did prepare a draft brief to the Governor in Council petitioning for disallowance of this legislation. The brief (described in Chapter VI) stressed the serious consequences to the Dominion and its citizens of this flagrant disregard for contractual obligations. This theme of the Social Credit contagion also found its way into a brief to Justice Minister Ernest Lapointe from W.N. Tilley.

> The Government might also well bear in mind that there is a real danger of the ideas of repudiation of debt, embodied in the Alberta legislation spreading to the other provinces, where governments may be forced to follow Alberta'slead. It is therefore important that any action which the Dominion Government may see fit to take be not deferred too long. The indirect effect of such intervention would not be confined to Canada, but would undoubtedly improve the credit position of Canada and her provinces in the money markets of the world. [787]

Again the implications were clear: the Dominion must prevent the social credit contagion from spreading. To do so would redound to the benefit of the Dominion's credit standing in world markets. The Dominion remained cautious in its approach making the distinction between protecting financial contracts and overruling legislation widely popular with the western population which had elected a great many Liberals the year before. The banks' rationale for taking a firm stand seems to be their well-placed fears that interest and principal reduction legislation might be extended from their application to mortgaged property and provincial debt into farm advances and the commercial credit. Another aspect of the banks' strategy was delivering to the Dominion a strong sense of expectation that the Dominion must act to protect its constitutional terrain. If the Dominion did not, the legal advisers pointed to the ill effects on the Dominion's credit rating should the Dominion fail to preserve its hegemony in the spheres of bankruptcy, interest, banking, and legal tender.

Declaration by the courts in February 1937 that the acts were beyond the competence of the provincial legislature did not bring peace to the financial institutions operating in Alberta. One Manager of The Bank of Nova Scotia in Alberta, F.G. Burr,

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[786] *Ibid*, p. 4. (emphasis added)
[787] W.N. Tilley, K.C. to Hon. Ernest Lapointe, Minister of Justice, 9 December 1936, Re. The Reduction and Settlement of Debts Act, The Debt Adjustment Act, 1936, The Provincial Securities Interest Act, The Municipal Securities Interest Act, The Alberta Credit House Act, p. 9. *The Bank of Nova Scotia Archives*, Secretary's Department Papers 1, File 153.

informed his General Manager that the court decision "is only going to make Mr. Aberhart go a little farther, and we are hourly expecting a proclamation of a general moratorium given him in the Debt Adjustment Act passed at the last session."[788] On February 23rd, an order in council was passed declaring a 60 day moratorium on all debts assumed before July 1, 1936.[789]

That June, the Legislature passed *The Postponement of Debts Act* authorizing the Cabinet "to postpone debt payments, prohibit issue of processes in courts of the Province and to stay proceedings in all civil actions."[790] If the Government was unable to protect the citizen's property (and civil rights) from the courts, it would prevent creditors access to courts to satisfy their claims. Similarly *The Debt Adjustment Act, 1937* also purported to limit the activities of creditors subject to the Debt Adjustment Board's permission and reaffirmed the Board's unconstitutional powers against the court's remedies of injunction, prohibition, *certiorari*, or mandamus.[791] This Act was disallowed in June 1938 shortly after the Liberal election Victory in Saskatchewan.[792]

Another ingenious statutory device employed to free debtors from their creditors was *The Judicature Amendment Act, 1937*, an omnibus bill, subsequently disallowed, which barred all courts from hearing legal challenges to provincial acts unless the provincial cabinet agreed![793]

The following April, *The Homeowners' Security Act* was passed to protect the mortgagors of farm homes and urban residences. The legislation protected the latter from foreclosure by requiring the creditor to deposit with the Court Clerk $2,000 in order to proceed with his legal claim. Without the deposit, action was automatically stayed. Should the creditor comply by depositing $2,000 and successfully repossess the home,

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[788]F.G. Burr to H.F. Patterson, General Manager, The Bank of Nova Scotia, 23 February 1937, *The Bank of Nova Scotia Archives*, Secretary's Department Papers 1, File 154. See also E.S. Thompson for the Secretary, C.B.A. to the General Manager, The Bank of Nova Scotia, 25 February 1937 who that in the wake of Mr. Justice Ewing's decision "care must be taken to avoid any appearance of a threat that the banks proposed to withdraw or restrict credit because of the moratorium.". *The Bank of Nova Scotia Archives*, Secretary's Department Papers 1, File 154.

[789]O.C. 188/37, 23 February 1937. The move was apparently prompted by fears of a creditor backlash enforcing overdue claims. See C.B.A. Confidential Letter A.W. Rogers, Secretary to H.F. Patterson dated 1 March 1937. Enclosure: "Report of Messrs. J. Walker and Frank Pike, Meeting with Aberhart, 25 February 1937," *The Bank of Nova Scotia Archives*, Secretary's Department Papers 1, File 154.

[790]1 George VI, Statutes of Alberta, 1937, Chapter 30, Section 2.

[791]1 George VI, Statutes of Alberta, 1937, Chapter 9, Section 27.

[792]P.C. 1367, 15 June 1938.

[793]1 George VI (Second Session), Statutes of Alberta, 1937, Chapter 5, Section 27c.

the $2,000 would then be released to the dispossessed enabling the person to purchase a new home![794] The creditor was caught in a Catch–22 position and the debtor in the envious position of receiving $2,000 which in those days was usually sufficient to buy a home outright.

This measure was especially irksome for the banks because they held between $16 million to $20 million of collateral mortgages in Alberta, that is, loans which were secured by residential property.[795] In addition, an amendment to *The Limitations of Actions Act, 1935* would further handcuff creditors in realizing on their assets.[796] Tilley, in an internal C.B.A. memorandum sketched out the alarming implications of this new legal weapon introduced by the Social Credit administration.

> In other words, bank debts incurred before that date (1 July 1936) where the debtor has not signed a renewal note and refuses to do so, will be outlawed in slightly over two years. It is evident that if debtors take advantage of this legislation to any great extent the effect upon the banks will be serious.[797]

This measure in conjunction with amendments being made to the Debt Adjustment Act, would, according to Tilley, "is practically impossible for a bank to institute any legal proceedings in Alberta, without the consent of the Debt Adjustment Board" known to favour debtors' interests.[798] Tilley believed it essential that the legislation be stopped

> While this statute is now in force, the effect of its provisions is not yet generally realized. It is important, therefore, that if anything at all is done to affect its operation, it should be done speedily for as soon as Alberta debtors become generally aware of its provisions it will be almost impossible for the banks to obtain signatures to renewal notes or other agreements of that nature.[799]

The fears of the past two years were now being confirmed in spades– no longer were the banks' assets only indirectly subject to depreciation. A growing frustration about the Alberta situation is apparent in a letter sent Finance Minister Dunning by C.B.A. President Sydney Dobson in May 1938. In referring to the Limitations of Actions Act, the

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[794] 2 George VI, Statutes of Alberta, 1938, Chapter 29, Sections 3–4.
[795] A.W. Rogers to General Manager H.F. Patterson, 26 April 1938, *The Bank of Nova Scotia Archives*, Secretary's Department Papers 1, File 155.
[796] *The Limitation of Actions Act, 1935, Amendment Act, 1938*, 2 George VI, Statutues of Alberta, 1938, Chapter 28.
[797] A.W. Roger to General Manager H.F. Patterson, 26 April 1938, Enclosure: Memorandum by W.N. Tilley, K.C. re. Effects of 1938 Alberta Legislation and Recommendations, pp. 8–9, *The Bank of Nova Scotia Archives*, Secretary's Department Papers 1, File 155.
[798] *Ibid*, p. 9.
[799] *Ibid*.

Homeowners' Security Act and the 1938 Securities Tax Act, Dobson asserted

> Such legislation as this is purely confiscatory and is designed to assist debtors without regard to the rights of or its effects on creditors of any class. It is intended to force creditors generally to compromise with their debtors, on terms dictated by the latter and approved by the Debt Adjustment Board. In a word, this is bankruptcy legislation which interferes with banking as well as with long term lending and with trade and commerce between Alberta and the other parts of Canada and other countries.[800]

Dobson also added these laws were "progressively disruptive of the moral fibre and common honesty of Canadian citizens in Alberta and neighbouring provinces."[801]

During 1939, additional legislation was enacted to *inter alia* prevent legal actions on debts and collateral security agreements after July 1, 1942 unless written renewals were obtained after, but not before April 1, 1939.[802] In petitioning for disallowance of the Act in September, the C.B.A. questionned "the arbitrary power of the Debt Adjustment Board indefinitely to withhold from creditors its consent to sue or take other proceedings to recover debt, the 1939 Act is intended to encourage wholesale repudiation in the semblance of compromise."[803] Furthermore, the Association asserted "no province should be at liberty to fetter banks in the delivery of services." In October, the Dominion acceded to the petitioners' request by disallowing this legislation.[804]

The final installment in the struggle between the debtor and the creditor came in the early 1940s. In January 1942, the C.B.A. filed for the disallowance of four acts: *The Debt Proceedings Suspension Act, 1941*[805], *The Orderly Payment of Land Debts Act,*[806] *The Municipal District Act, Amendment Act, 1941,*[807] *and The Limitation of Actions Act, Amendment Act, 1941.*[808] The C.B.A. alleged:

> a startling sequence of persistent attacks upon Canadian banks and other

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[800]C.B.A. Confidential Letter, A.W. Rogers, Secretary to H.F. Patterson, General Manager dated 26 May 1938, Enclosure: Dobson to Dunning, 14 May 1938, *The Bank of Nova Scotia Archives*, Secretary's Department Papers 1, File 159.

[801] *Ibid*

[802]*The Limitations of Actions Act, 1935, Amendment Act, 1939*, 3 George VI, (Second Session), Statutes of Alberta, 1939, Chapter 80.

[803] A.W. Rogers, Secretary C.B.A. to H.F. Patterson, General Manager dated 15 September 1939. Enclosure: "Petition for Disallowance of Certain Legislation enacted by the Legislature of the Province of Alberta," dated at Montreal, September 8, 1939, p. 5, *The Bank of Nova Scotia Archives*, Secretary's Department Papers 1, File 156.

[804]P.C. 2949, 4 October 1939.

[805] 5 George VI, Statutes of Alberta, 1941, Chapter 41.

[806] 5 George VI, Statutes of Alberta, 1941, Chapter 47.

[807] 5 George VI, Statutes of Alberta, 1941, Chapter 53.

[808] 5 George VI, Statutes of Alberta, 1941, Chapter 62. This Act, like its predecessors purported to alter the time frame within which actions must be brought in judgments relating to mortgages, promissory notes, and other financial claims.

> financial institutions. The statutes of which disallowance is now asked constitute another attempt by the Alberta Government to attain the same end. Efforts to bar corporate creditors from the courts have been made repeatedly, in various guises. They are all designed to deny justice to banks and other corporations whose funds, loaned to Alberta borrowers, have contributed greatly to the progress and wealth of that province. The debts of Alberta to the banks and to other lenders have been the subject of attack and values of securities have been depreciated. The province has also attempted the imposition of discriminatory and confiscatory taxes. All these activities demonstrate that the province, having been prevented from reorganizing the entire credit system. still seeks to frustrate and weaken the present system by every conceivable means.[809]

Again the Dominion listened carefully to what the banks' legal advisers said and disallowed three of these acts in March 1943 with the exception of *The Municipal District Act, Amendment Act*.[810]

In the war against financial "dictatorship", the Province shifted its emphasis from protecting debtors against creditors to protecting debtors against the mainly federally appointed magistrates. The Province meanwhile was able to evade the bondholders' claims to at least one half the interest and defaulted principal because debentures were not pledged against any provincial assets or revenues unlike certain bank loans mentioned earlier.[811] In the case of private debts, a legislative pattern of enactment, court challenge or disallowance and moratoria evolved which gave temporary relief to debtors and a massive headache to lenders.

Banking Legislation

The first indication of the Government's plans to impose heavier taxes on the banks came in mid-February 1937 with the growing rumour of amendments to The Corporations Taxation Act. Jackson Dodds telegraphed Dudley Dawson, Acting C.B.A. President advising against any preemptory, retaliatory measures.

> There would be no harm in banks having someone to informally approach Premier and refer to these rumours of tax on financial institutions endeavouring to ascertain his attitude and *intimate that any further heavy levy on banks will certainly result to detriment of Province.*[812]

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[809]A.W. Rogers to General Manager H.D. Burns, 20 January 1942, Enclosure: C.B.A. Petition for Disallowance, Dated at Montreal, 20 January 1942. Para. 14, *The Bank of Nova Scotia Archives*, Secretary's Department Papers 1, File 156.

[810]P.C. 2350, 27 March 1942.

[811]Normally institutional holders refused to accept half-payment for fear that acceptance would prejudice their recovery of the full rate contracted.

[812]Telegram, Jackson Dodds to Dudley Dawson, quoted in letter, A.W. Rogers, Secretary, C.B.A. to H.F. Patterson dated 12 February 1937, *The Bank of Nova Scotia Archives*, Secretary's Department Papers 1, File 158. (emphasis added)

Accordingly, a meeting was arranged in March at which time the C.B.A. representative appealed for a lower tax on the basis of a lower volume of business in the Province. In reply, Dr. Cross, then Minister of Trade and Industry stated that "the banks were lending to eastern manufacturers who sold goods in the west at a profit, whereas the western producers were being forced to sell their goods at a loss, and that it was only right that some of the money derived by the banks from eastern manufacturers should come back to the west in the form of taxes." A "compromise" however, was offered the bankers. If the banks agreed to lend the Government $10 million at three per cent to provide for the redemption of the provincial savings certificates (then in default) pledged against certain provincial revenues, the proposed tax might be dropped.[813] This proposition naturally failed for it should have been apparent that no bank would be willing to lend money to a debtor that was in default, let alone at preferential rates.

Subsequently, it was decided by the C.B.A. that further representations would be a waste of time and plans were laid to retaliate against the rumoured tax. That March, a variety of tactics were mooted inside the Association to encourage Alberta to see the futility of its policies. Proposals included:

1. A turnover charge of 1/64 of one per cent on all debit entries of Alberta savings accounts.
2. Interest on savings accounts to be reduced by one quarter of one per cent and interest charged to be raised by one quarter of a per cent, not to exceed the legal maximum of seven per cent.
3. The closing of 50 or 60 bank branches.[814]
4. Imposition of a charge for cheques.[815]

The general consensus seemed to be that savings rates should be lowered and this move be publicized as the product of unfair, discriminatory bank taxation.

The matter remained dormant until passage of *The Corporations Taxation Act, Amendment Act, 1937* when plans were resumed to cut interest payments. At least two banks were unhappy about the suggested savings deposit rate reduction, including The Bank of Nova Scotia, which did not agree that depositors should be penalized as a result

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[813]A.W. Rogers to General Manager H.F. Patterson, 9 March 1937, p. 2, *The Bank of Nova Scotia Archives,* Secretary's Department Papers 1, File 158.
[814]The tax on bank capital and reserves proposed by Aberhart was specifically designed to prevent this manoeuvre.
[815]A.W. Rogers to General Manager H.F. Patterson, 9 March 1937 and 15 March 1937, *The Bank of Nova Scotia Archives*, Secretary's Department Papers 1, File 158.

of the misguided policies of their provincial government.[816] As noted above, Graham Towers when learning of the plan at the end of June dissuaded the banks urging them to fight on the line of Dominion–wide banking and committing his support to the protection of the chartered banks in Alberta.[817]

During the 1937 mid–summer sitting of the legislature, the Social Credit administration went considerably beyond its earlier attempts to hamper banking operations in the province as recommended by Major Douglas. In early August, *The Credit of Alberta Regulation Act* was assented to.[818] This certainly unconstitutional act purported to "license" bankers and bank employees and provided for the appointment of "local bank directorates". The Act also imposed penalties of $10,000 per day for banks operating without the requisite license. The reservation of this Act lends credence to our earlier assertion that the credit of the Dominion and the banks were inextricably tied. Had the Dominion condoned this form of licensing and taxation, it would have invited a wholesale assault on financial instititions and financial contracts. The rapid use of disallowance and the rare use of the power of reservation suggests, in the words of *The Monetary Times* that the "Gilbert and Sullivan" play between Ottawa and Edmonton was reaching a climax.[819] The rapid response of the Dominion to these measures probably came as a bit of a shock to some members of the Social Credit Administration for King's declarations during the 1935 election campaign designed to cultivate western support indicated the Liberal Prime Minister might allow the Alberta experiment to proceed without federal interference.[820]

The contrast between the Dominion's treatment of debt moratorium measures and banking legislation is instructive for several reasons. As Professor Mallory has suggested the power of disallowance tended to be used on behalf of interests with sufficient resources to test the validity of provincial acts.[821] But why did the Dominion disallow acts purporting to license banks and bank employees, but at the same time allow legislation equally damaging to finance capital, notably loan and mortgage companies, dealing with

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[816]H.F. Patterson to A.W. Rogers, 30 June 1937, *The Bank of Nova Scotia Archives*, Secretary's Department Papers 1, File 158.
[817]Towers Memoranda, No. 151, 22 June 1936, "Telephone Conversation with Dobson, C.B.A.," p. 2, *Bank of Canada Archives.*
[818] 1 George VI (Second Session), Statutes of Alberta, 1937, Chapter 1.
[819]"Alberta Nearing a Climax," 2 October 1937, p. 6.
[820]Hooke, 1981, pp. 40–41 and Government of Alberta, Bureau of News and Information, "Democracy Denied," (Edmonton: n.d.), p. 4.
[821]Mallory, 1976, p. 176.

interest and debt reduction, to go into court? The most obvious answer is given in Towers' remarks concerning the interests jointly shared by the Dominion and the banks. Clearly, the Dominion was not prepared to abdicate its responsibilities over banking which would have made economic management even more difficult in a period characterized by the absence of governmental institutions directing or managing economic policy. Secondly, the Dominion's reluctance to disallow debt reduction legislation was its wide popularity in Western Canada for debtors outnumbered creditors and the economic circumstances were propitious for legislators to impose legislative roadblocks against creditor institutions. And as stated in the document submitted by the Dominion to the Imperial Conference in 1937, the remedy for acts that were "constitutional" but "objectionable" lay with the electorate of the province concerned.[822] Moreover, to strike down Alberta's legislation and at the same time to permit the Saskatchewan Liberal administration's laws to stand would have been highly partisan and politically dangerous. Another reason was the considerable doubt in the minds of the legal profession on he actual judicial decision in a constitutional reference as to where the courts would come down between "property and civil rights" and "interest" and "bankruptcy". In retrospect, it was not surprising that the conservative tradition of the courts should uphold the sanctity of financial contracts.

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[822]Imperial Conference, Department of Finance, "Interest Reduction Legislation of the Province of Alberta," June 1937, pp. 9–10, *Bank of Canada Archives*, "PF2– Provincial Financing Alberta, 1937–1942."

TABLE 9.8

Fate of the Social Credit Legislation

RESERVED
The Bank Taxation Act
The Credit of Alberta Regulation Act, 1937

DISALLOWED

The Bank Employees Civil Rights Act
The Credit of Alberta Regulation Act
An Act to Amend the Judicature Act, 1937
The Homeowners' Security Act
The 1938 Securities Tax Act
The Alberta Social Credit Act
The Debt Adjustment Act, 1937
The Limitation of Actions Act, 1935, Amendment Act 1939
The Orderly Payment of Land Debts Act
The Debt Proceedings Suspension Act, 1941

DECLARED UNCONSTITUTIONAL

The Reduction and Settlement of Debts Act
The Provincial Securities Interest Act
The Municipal Securities Interest Act
The Provincially Guaranteed Securities Proceedings Act
The Provincial Government Securities Interest Act
The Alberta Social Credit Act (repealed 1938)
The Debt Adjustment Act, 1937, Amendment Act, 1941
The Legal Proceedings Suspension Act, 1941

LEFT INTACT

The Corporations Taxation Act, Amendment Act, 1937
The Treasury Branches Act
The Municipal District Amendment Act, 1941

Public Relations Initiatives

It was not until the reduction of interest payments on the provincial debt was proclaimed on May 30, 1936 that a meeting was held of institutional bondholders in Toronto. At this informal meeting of 25 representatives of insurance, mortgage, trust and loan companies and chartered banks, there existed grave misgivings as to "what length the Alberta Government eventually might go unless some group (naturally the bondholders) discussed the whole matter with the Government."[823] Curiously, the banks felt it necessary to solicit Towers' opinion on the matter. Towers replied he felt the committee was

[823]C.B.A. Circular 157-A, A.W. Rogers to The General Manager dated 30 May 1936, *The Bank of Nova Scotia Archives*, Secretary's Department Papers 1, File 153.

"greatly needed" and that bank representation would "strengthen" the situation. George W. Spinney of the Bank of Montreal was named the Association's representative. However, apart from the report sponsored by the Bondholders' Committee known as the "Elliott–Walker Report", meetings with the Government grew fewer and fewer as the Aberhart Government became embroiled in various legislative schemes to vitiate creditors' claims. Indeed, it was only after Aberhart's death and Solon Low's departure for Ottawa that representatives from Wood Gundy and The First Boston Corporation met with Frank Percival, Ernest Manning and the Provincial Auditor Keith Huckvale to work out a debt reorganization plan.

While these efforts at a reconciliation were proceeding at a snail's pace, H.R Milner recommended in September 1936 a clandestine funding arrangement to funnel moneys towards anti–Aberhart news and information organizations. Milner's recommendations are interesting because they reflect a greater awareness of the animosity directed at the banks by the population than the analysis of bankers cloistered in Montreal and Toronto. Moreover, he was aware of the great organization, oratory, public relations, and commitment on the part of the Social Credit forces.

> An Alberta committee [wrote Milner] is exceedingly dangerous. The money should be collected in the East and from the Western people who are interested, and should be given to one man whose name should not be known to more than two Eastern men at most and everything should be left to his judgment.[824]

Thus, the seriousness of the situation and perhaps its ludicrousness is illustrated by the suggestion of a clandestine money laundering operation worthy of the C.I.A. In analyzing the prospects for using media outlets and influencing news, Milner observed that of the rural dailies and weeklies run mainly by independent operators, only three or four should be used. While *The Calgary Herald* was supportive, *The Calgary Albertan* was under Aberhart's control and *The Edmonton Journal* lacked "intestinal fortitude." Milner recommended the purchase of a controlling interest in the Calgary radio station "Voice of the Prairie" for about $35,000.[825] The foregoing reveals the sweeping plans recommended to combat the threat of expropriation of institutional creditors and this strategy

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[824] C.B.A. Confidential Letter A.W. Rogers, Secretary to the General Manager, The Bank of Nova Scotia dated 28 September 1936. Enclosure : Memorandum dated Sept. 18, 1936, prepared by H.R. Milner, K.C.", p. 3, *The Bank of Nova Scotia Archives*, Secretary's Department Papers 1, File 153.

[825] *Ibid*, pp. 2–3.

recognized the importance of influencing the dissemination and interpretation of news stories.

In October 1936, the C.B.A. in attempting to win its case with the Alberta public requested bank managers to report cases of actual hardship of those suffering under "Mr. Aberhart's doctrines."[826] The stated objective was "a view tobring home to the *electorate* the damaging effect of such legislation, not only to those possessed of means, but as well to the man in the street."[827] In the case of The Bank of Nova Scotia's canvas only two instances of hardship were obtained including one newsclipping. F.G. Burr reported

> As you can well surmise, we hear all sorts of stories of hardships that have been caused by the Provincial legislation in this Province, but it is practically impossible to pin these stories down to any actual cases. I have made discreet enquiries from trust and loan companies and lawyers, but have not been able to get anything that would be of value to you.[828]

This finding should have been no surprise in a region where only the privileged would suffer from reductions in interest payments and those who had been foolish enough to place all their savings in certain Alberta assets.

The importance of a stronger media voice to counter Social Credit agitation culminated in the Canadian Bankers' Association's announcement in December 1936 of the appointment of Vernon Knowles, former Managing Editor of the *Winnipeg Tribune* as "Public Relations Adviser".[829] In aiming to counter Social Credit's message, C.B.A. ads were directed at refuting the fallacies spread by Aberhart and others about commercial banking and credit. One such advertisement emphasized that "bankers cannot perform miracles."[830] In rebutting the monetary reformers' accusations of a money power, Knowles cleverly pointed to the new institutions of the Bank of Canada and Inspector-General of Banks[831] to emphasize that banks were no longer a power unto themselves, if they ever were. Another advertisement opined, perhaps with tongue in cheek, that "any group of responsible citizens who will get $500,000 in capital subscribed and half of it paid up, and

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[826]C.B.A. Circular 163-T, 21 October 1936, *The Bank of Nova Scotia Archives*, Secretary's Department Papers 1, File 153.

[827]J.G. Rogerson, Secretary, The Bank of Nova Scotia, to F.G. Burr, Manager, The Bank of Nova Scotia, Calgary, dtaed 22 October 1936, *The Bank of Nova Scotia Archives*, Secretary's Department Papers 1, File 153. (emphasis added)

[828]F.G. Burr to Mr. Rogerson, Secretary, The Bank of Nova Scotia, 13 January 1937, *The Bank of Nova Scotia Archives*, Secretary's Department Papers 1, File 153.

[829]This move was greeted with glowing praise from *The Monetary Times*, "The Banks Make a Good Move," 2 January 1937.

[830]Placed in *The Monetary Times*, 25 June 1938 and major Alberta dailies.

[831]Set up in 1926 in the wake of the Home Bank failure.

who fulfil the requirements of the Bank Act, can start a bank."[832] This claim was made in spite of the fact that a bank charter had not been issued in Canada for over a decade; hardly a record which suggested competition and free entry into the business of banking.[833]

Another dimension of the banks' propaganda was to convince the public of the dangers of the socialization of credit. "Credit– It belongs to you– the community does not own it," read one ad which appealed to freedom–loving, enterprising individuals who were responsible and a sound risk. As well, the banks stressed their fiduciary role by stating "because of the bank's responsibility to its depositors it can make loans only where repayment is certain," obfuscating the ability of banks to create overdrafts and guarding against charges that banks were unwilling to lend.[834] The banks during this period were promoted as secure financial bastions protecting the lowly individual's hard–earned credit and savings against the claims of the unwashed masses seeking special favours. In this crusade to redefine their function as trustees of the savings of the ordinary folk, the banks were solidly supported by the ideologues in the financial press who failed to mention who owned the banks that "looked after" the savings of millions of Canadians.[835]

The other major facet of this campaign of advocacy advertising purported to present "A Few Candid Words About Bank Earnings." In a fashion strikingly parallel to recent C.B.A. efforts to build public credibility, readers were informed that "half of one per cent a year on total assets is not much of a profit margin for any business, corporate or individual." Predictably, the reader was then apprised on the banks' central role in Canada's economic life in terms of payroll expenditures, employment and tax payments.[836]

While it is difficult to estimate the impact of this campaign and similar radio messages upon the Alberta population, in retrospect, it seems safe to say its impact was minimal neither strengthening nor weakening the resolve of the devoted Social Crediter or

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[832] Placed in *The Monetary Times*, 9 April 1938 and various Alberta dailies.
[833] The last bank chartered in Canada before 1937 was the Barclays Bank later merged with the Imperial Bank of Canada. Between 1910 and 1928, four banks were issued charters; one in Quebec, one in the Maritimes, and two in Western Canada. None of these charters were ever used. Sarpkaya, 1980.
[834] Placed in *The Monetary Times*, 14 May 1938, p. 542 and the various Alberta dailies.
[835] For instance *The Monetary Times*, "Who Owns the Wealth?" 24 October 1936.
[836] Placed in *The Monetary Times*, 24 September 1938 and various Alberta dailies. Earlier broadcasts and publications put out by the banks were praised as valuable by Graham Towers during a meeting with bankers in November 1937. Towers Memoranda, No. 77, 23 November 1937, "Governor's Conversation with the Bankers in Toronto, November 18, 1937," *Bank of Canada Archives*.

the staunch bank supporter. The C.B.A.'s decision to hire a public relations adviser is instructive for it indicates the seriousness with which Social Credit was regarded by central Canadian bankers. No longer were august annual sermons to shareholders' meetings, published in many Canadian dailies, sufficient to ward off thoughts of repudiation and Social Credit, the Aberhart movement certainly forced the banks to take a more active role in shaping the public's perception of their role.

What remains perplexing about the banks' behaviour in Alberta is their slow reaction to the spread of Douglasism in this province. To be sure, the newspapers did not give Aberhart much attention until early in 1934. Still, the arrival of Major Douglas in May 1934 to testify before a committee of the legislative assembly, should have certainly alerted the banks to the potential dangers of the movement. And yet, Aberhart and his followers were cavalierly dismissed as "cranks" by bankers and academics who failed to recognize the growth of a potent social and political movement. Even during the election campaign, there seemed to be little expectation that Aberhart would emerge victorious and this is reflected in bond price movements up until the week of the election. Indeed, many observers were duped into thinking or hoping that Alberta would return a Liberal Government to make the party's domination complete from sea to sea.[837] Only after the unthinkable had happened were discussions held and plans devised to close out branches and move assets into Saskatchewan and British Columbia. In general, the banks were mainly reactive to political developments in the west. This tendency to react rather than create conditions more favourable to banking in Alberta is exemplified by the ill-advised recommendations circulating in 1936 and 1937 to retaliate against the government's legislation.

With the support of the Dominion and the courts, the creditors belatedly enforced their claims and the banks were able to carry out their business. However substantial costs were involved including the substantial legal fees incurred. Internal C.B.A. documents also show that in 1936 nearly one fifth of bank branches in Alberta lost money and that between July 31, 1935 and April 30, 1936 nearly $7 million left the province's bank accounts. The C.B.A. also calculated that $7 million was lost in the province during the

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[837]Bracken's Progressive-Liberal government, though not formally Liberal, was regarded as friendly by King.

years 1926 to 1937.[838] While such figures should be taken with a grain of salt, it is undoubtedly true that the Province was able to inflict severe damage on the profitability of banking in those years.

Summary

C. Wright Mills in his classic study *The Power Elite* posits a number of power elites– the military, the corporate, and the political which, to some extent compete, but still share some fundamental assumptions about the socio-political system. This ideological allegiance is tested from time to time, he says, when these elites draw ranks in order to defeat any fundamental challenge to the existing social order.[839] This thesis is particularly suggestive when adapted in the context of the Alberta situation. In this situation, domestic finance capital and the Dominion Government's core institutions, sensitive to the needs of foreign finance capital, used their constitutional and financial resources to nip Social Credit in the bud.

As Major Douglas had forecast, default signalled the opening salvo in a war against the money power that would be waged for nearly one decade. Following the default, banks still remained somewhat inactive until passage of legislation which had the effect of depreciating their collateral mortgages held in that province. There were four main elements in the banks' programme to defend their prerogatives. Firstly, the preparation of extensive legal briefs to the federal cabinet urging disallowance. Explicit in these submissions was the opinion that disallowance would protect, if not enhance, the Dominion's own credit standing. In these briefs and letters, the banks implored the Government to stop these confiscatory measures which, if allowed to continue, would destroy the financial assets of Canadian finance and the foundation of the economic system, leading in turn to the impoverishment of all citizens, rich and poor.

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[838]C.B.A. Circular, 5 March 1937, "Report of Walker and Pike– Aberhart Interview, 2 March 1937," and C.B.A. Confidential Letter, A.W. Rogers to H.F. Patterson dated 5 March 1937. Enclosure: "Copy of Telegram dated 4 March 1937 refferring to meeting of Walker and Pike on March 2 1937, *The Bank of Nova Scotia Archives*, Secretary's Department Papers 1, File 158 and A.W. Rogers to H.F. Patterson, dated 26 May 1938, Enclosure: S.G. Dobson, C.B.A. to Hon. C.A. Dunning, Minister of Finance, dated 14 May 1938, *The Bank of Nova Scotia Archives*, Secretary's Department Papers 1, File 159.
[839](New York: 1973), pp. 276-278.

Secondly, the C.B.A. did attempt to dissuade the Premier in private discussions. Representatives very soon concluded that Aberhart would not listen to "reason"– his actions being informed presumably by sources in another place. Thirdly, the bank creditors attempted to use radio and newspaper advertising to counter Social Credit propaganda. In spite of the drying up of industrial and agricultural credit during six years of depression and the criticism of banks before the Macmillan Royal Commission, bankers until 1936 did not feel the need to mould public opinion. Whether this was due to feelings of false security, an inherent arrogance or stupidity, is perhaps immaterial; their slowness in this respect betrays a weakness in terms of the banks' political *savoir faire*.

Finally, as was discussed in Chapter VI, the banks were careful in seeking the counsel of Graham Towers and Clifford Clark. These discussions were fruitful from the banks' point of view in assuring themselves that the central bank and Dominion Government was on their side. Furthermore, it gave the bankers an opportunity to reinforce their expectation that the Dominion would act accordingly, that is, use constitutional means to retard the programme of Aberhart. The Alberta situation also allowed the central bank to build up a reserve of credibility by offering sound advice in preventing any blunders by the banks in the public management of this crisis. In sum, the banks and the Dominion worked together to defeat an assault on Dominion powers and on the sanctity of contract, i.e. on the basic political and economic order.

This confrontation also teaches several lessons about the nature of public debts and the importance of good debt management. First of all, the crisis of Alberta public finance demonstrates the dangers to the issuer of the optional–payment bond and more generally the difficulties of foreign borrowing. Secondly, Alberta did not follow the maxim of flexibility in managing its debts by ensuring that call features could be available when bond yields fell. To be fair, the Province was not unusual in this respect as investors continued to vigorously resist the call provision. Thirdly, the maturity structure was dominated by too many long–term issues which again did not permit the debtor to take advantage of declining rates.

The Alberta experience also drives holes into the benign theory that "we owe it to ourselves". In Alberta's case, the debtor province was not home to many coupon clippers and so the theory of taxing interest to pay for interest was a bad joke. Alberta's default

brings into doubt the theoretical position that there is no inter-generational transfer of the debt burden. This was not the case for the inheritance of Liberal Government debts by the U.F.A. and Social Credit governments, combined with a fall in tax revenues, left substantial IOUs dictating a heavy increase in taxes. And finally, the sad legacy of unproductive public investments which further exacerbated the crisis of public finance lends additional empirical evidence to the position that if the future benefits do not meet the future financing costs of a project, a debt burden results.

We began this chapter by posing the questions: "Why did the Dominion, which prior to April 1936 had been so willing to advance moneys to provincial debtors to prevent default, refuse to guarantee Alberta's financial commitments?" and "Why did the Dominion single out Alberta for special treatment while continuing to lend to Saskatchewan, Manitoba and British Columbia?" After analyzing the initiatives taken by the Province and the reaction of the chartered banks to these measures, it becomes evident that the protection of the Dominion's credit standing could best be served by Alberta's default. The great fear that Social Credit would spread like a prairie fire was implicit in many editorials and communiques by bankers, lawyers and Dominion officials. The Dominion concluded that in this context, Alberta which had moved too far in interfering with federal prerogatives, should be cut adrift in order for the Dominion to regain credibility with the international and domestic financial fraternity by acting decisively in this matter. Alberta was successfully isolated and the Dominion's credit standing was strengthened as a result.

X. CONCLUSION and SUGGESTIONS FOR FURTHER STUDY

At the outset of this study, attention was drawn to the current debates surrounding the federal government's unprecedented peace–time deficits. Some observers believed the deficit was out of control, while others felt the deficit was not a problem and in fact have recommended a stimulative policy which would widen the deficit further. The focus of this investigation has been the study of the financial legacy of these recurring deficits– the national or public debt. The *raison d'etre* advanced for exploring this area of public finance was to shed light on the "other side" of government revenue raising– borrowing and the management of borrowing operations. Debt management, it was argued, is politically significant because both the value of the monetary unit and the rate of interest have a profound influence on the political agenda of states.

Some of the studies of the state in capitalist society, notably the work of Ralph Miliband and Leo Panitch, stress the symbiosis of state and monopoly capital, the international forces which compel this symbiosis, the internationalization of finance and commerce, the conservatism of the civil service, and the socialization processes which legitimize the inequality in the distribution of wealth and income in society.[840] Studies by sociologists explain the close relations between the state and industrial and financial corporations by listing the kinship and organizational linkages of elites in the state, para–state, and corporate sector.[841] This sociological explanation stresses the common educational, social and economic backgrounds cultivating shared beliefs about the fairness and soundness of the existing social, economic, and political order. These studies tend to complement the more structural analyses undertaken by political scientists which downplay the issue of personal relationships.

In order to gain a better understanding of the interplay between state and private sector actors and institutions, an historical survey of an important, though largely unmapped function of governmental activity, debt management, was undertaken. This focus may be justified by (1) Canada's historical needs as a "hinterland" for portfolio investment to finance economic development, (2) the central role played by the federal

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[840]*The State in Capitalist Society*, (London: 1972) and Panitch, "The role and nature of the Canadian State," in Panitch, (ed.), 1977, pp. 3–27.
[841]Wallace Clement, *The Canadian Corporate Elite*, (Toronto: 1975), Dennis Olsen, *The State Elite*, (Toronto: 1980), and John Porter's classic, *The Vertical Mosiac*, (Toronto: 1965).

state in economic development through its superior borrowing capacity, and (3) the importance attached in Canadian business history to the role played by financial intermediaries, primarily the banks.

To assess the relative independence of the Dominion *vis-a-vis* its creditors the particular historical and political context in which these relations evolved must be first understood and appreciated. The varying circumstances of the period under consideration were especially conducive to governmental intervention in the nation's economic life. Had it not been for the brutal contraction of credit during 1930–33, a Conservative government would hardly have been expected to have commissioned a study on Canada's banking system. It is equally unlikely that the Dominion would have been able to compel banks to lend the Government money at or below cost had it not been for the existence of exchange controls necessitated by all–out war.

Secondly, in undertanding the context for debt management, institutional change must be taken into account, in particular the establishment of the Bank of Canada. As economic circumstances forged new political demands, so too did the evolution of institutions alter permanently the nature of economic relations. The Bank of Canada not only gave the debtor–state more room to manoeuvre in its dealings with institutional creditors, it was also able to foster the conditions which would eventually lead to a broader, more impersonal market in government securities. As this study is, in effect, a case study covering a period of great institutional change, the conclusions expressed herein must be regarded as tentative and not to be regarded as a general theory of the debt management process.

Politics and Debt Management

In order to provide a broader perspective on the debt management function, the general economic philosophies of the main political parties were surveyed in Chapter IV. This examination served to contrast the traditional attitudes to public finance of the Tories which remained relatively constant in contrast with the evolving attitudes of the Liberals in and outside government. The Liberals' re–orientation evolved from the continuing debate on economic policy throughout the Depression and war–time and was prompted by fears of (1) a return to depression and (2) a C.C.F. electoral victory. The fear of the C.C.F. was

used several times by senior Liberal politicians to undercut the arguments of conservative officials who advised a more orthodox approach to financial matters.

The review also showed that the counter-cyclical policy adopted in 1945 was clearly circumscribed by electoral considerations. Records of private conversations, admittedly few in number, confirm the often-voiced suspicions of the opposition that budgetary policy was influenced unduly by the proximity to a federal election.

Officials previously engaged in the field of debt management stated to the author that this function was basically apolitical, that its conduct was solely administrative or technical in nature. There were two main areas in which the minor parties, the Social Credit and the C.C.F., had some practical influence however. Firstly, during discussions with the banks in the Depression and the war, officials and politicians made reference to the demands of the monetary reformers using these demands as leverage to encourage their institutional creditors to take a more reasonable approach lest the reformers come to power. And secondly, the distribution of the debt also was debated frequently by C.C.F. and Social Credit members. The salience of this feature of the national debt encouraged the Government during and after the war to widely publicize loan campaigns and to place the debt with as wide a segment of the population as possible. This goal, to democratize the debt, led to problems after the war when monetary policy was subordinated for a time to debt management policy to keep faith with the millions of small investors who had purchased Victory bonds. The impossibility of keeping these marketable bonds at par, recognized by both Social Credit and C.C.F. spokesmen, led to the development of a new savings instrument which would eliminate possible accusations that the small folk were being ripped off through manipulated prices on the bond market.

Although Parliament is ultimately supreme in these matters, it has no effective way of demanding that maturing debt be paid off except by amending the Financial Administration Act. With the exception of the incident in the summer of 1982 when the Conservatives succeeded in forcing the Finance Minister to lower his borrowing request, parliamentarians rarely politicize the level of the public debt. Only during extraordinary circumstances, as in a depression or a war will the rate of interest and the volume of debt be the subject of an extensive debate on the floor of the Commons. As a result of this disinterest, the management of the public debt and its ramifications for the level of

interest rates rest with technocrats whose allegiance is to the market and not to parliament. As a consequence of this indifference to the mounting debt and the proclivity of western governments to bribe their citizens with borrowed money at election time, Canadian taxpayers were paying, on average, 14 per cent to service the $90 billion national debt in fiscal 1981-1982. One possible means of preventing political parties in legislatures from bribing the electorate is to force governments to balance their budgets by raising taxes to cover projected deficits except, of course, during extraordinary periods like war-time. A more satisfactory proposal, which might meet the objections of Keynesians, would be to permit borrowing only to the extent that this borrowing was earmarked for public capital projects whose stream of benefits are long-term in nature.

Debt Management- Objectives and Obstacles

This study reveals quite clearly that the primary objective of debt management was *interest rate minimization*, to refund and issue new debt at as low a rate of interest as possible. Secondly, the debt manager sought to place the debt with a minimum amount of disturbance to the capital markets. These principal objectives meant that the debtor and the debt manager, in order to obtain funds at a reasonable cost, would have to borrow according to the rules of the game, that is, to maintain investor/market confidence and to keep provincial governments afloat. The other goals of debt management, that of a balanced maturity structure, lengthening the term to maturity of the debt (funding), and maintaining flexibility through issuing bonds with a call feature were important, though subsidiary goals. In order to minimize interest charges, the debt manager monitored capital markets very closely and attempted to ensure that there would not be clashes with other borrowers when coming to market e.g. the Federal Reserve in New York, the Province of Ontario in Canada. Another important subsidiary goal pursued after the central bank's creation was to widen the distribution of the debt held by the general public. The achievement of this objective was accelerated by the Second World War with the sales of billions in Victory Loans to Canadians with the payroll savings campaign being particularly successful. After the war, this marketing formula and structure were largely retained. However, the large sums cashed in after interest rates started their rise in 1949 underlines the inherent conflict between democratization and cost minimimization in the

distribution and servicing of the debt.

The main obstacle in achieving these goals was the dominance of the chartered banks at the short end of the market in the early thirties reducing the government's ability to fund the debt at rates set in a more perfectly competitive money marketplace. The second principal obstacle was the form of the debt, notably the absence of call features and the tax–exempt feature which rendered the early conversion loans more difficult. Canada Savings Bonds, instruments which are cashable at any time, were sold in a tap issue and now represent nearly one–third of the outstanding federal debt. While significant in demonetizing and democraticizing the debt, the costs of these campaigns and the frequency with which these bonds are cashed do not make this instrument very cost effective. Nevertheless, they have an important educative and ideological effect on a nation of savers who may feel they have some claim on the income of the state.

Ironically, the goal of widening the distribution of the debt also proved to be an obstacle in terms of a smooth marketing of new issues. The moral commitments made by Ilsley and Towers during the War left the central bank and the Government in the delicate position of maintaining bond prices well after economic indicators portended a rise in interest rates. The fear of a major sell off of bonds and the possibility that new war loans might have to be raised from the public caused the debt manager to support bond prices, a move which tended to make market analysts wary about a possible break in bond prices. This episode again pointed to the political attractiveness of the savings bonds' cash redemption feature and the difficulties in controlling the markets when bonds were being sold to purchase houses and consumer durables.

Currently, debt management objectives have become subordinated to the goal of maintaining a high value for the Canadian dollar. This goal is intelligible in terms of the needs of debtors tied to the New York money market, namely the provinces of Quebec, Manitoba, Ontario, and British Columbia. This policy first was begun in 1947; but through borrowing as a temporary expedient to buoy up the Canadian dollar, the structural problems of the export of Canadian capital and Canada's weak manufacturing sector have been constantly deferred. These policies then have produced a "made in New York" interest rate policy meaning that the goal of interest rate minimization depends on U.S. Treasury–Federal Reserve Board decisions.

The Money Power

The Banks

> People of the same trade seldom meet together even for merriment and diversion, but the conversation ends in conspiracy against the public, or in some contrivance to raise prices.
>
> Adam Smith[842]

The behaviour of banks also conforms, by and large, to behaviours predicted from "balance sheet" considerations. The imperatives of the balance sheet led banks to maximize the spread between their returns on securities and loans and deposits kept with the banks. As banks' portfolios of government holdings increased during the 1930s and during the War, it became of paramount importance to maximize returns from "Canadas" while minimizing savings rates. As the largest holders of maturing issues, the banks had an advantage over other holders when it came to bargaining with the Government. The creation of a central bank resulted in "negotiations" on conversion offers being gradually brought to an end. Thus, the behaviour of the banks both as individual profit maximizers and as an industry is in close conformity with the predictions of economic theory and interest group theory. While it is true that Canada's capital market took its signals from London and then New York, archival records show that Canada's short-term capital market was, for all intents and purposes, an inter-bank market and so even if the banks pointed to "market prices", those prices were set by the buying and selling that went on between half a dozen banks.

The drawbacks to this cosy system characterized by non-arms-length market arrangements with the government was fully demonstrated in the 1934 Autumn financing when the Dominion endeavoured to lower the rate of interest. This resulting agreement lowered the rates paid depositors in banks and trust companies which represented the largest liability of the chartered banks and was an arrangement which clearly violated the spirit of Canada's anti-combines laws. This episode confirmed the debt manager's goal of interest minimization but also demonstrated the need for an institutional mechanism which would at least partially restore the Government's sovereignty (as opposed to Parliament's) in the field of money, interest, and credit. Further, the arrangement illustrated how closely the credit of the Dominion and the banks were related.

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[842]Smith, 1970, p. 232.

Still, did this non-market system of loan negotiations lead the Government to assign the direction of its economic policies to the chartered banks? Was the money-lender, in Tawney's terms, the real power behind the Canadian Cabinet manipulating the political marionettes? From the historical evidence presented, one can safely say that the Government was certainly well apprised of the *expectations* of bankers on such matters as railway deficits, railway re-privatization, and the need for balanced budgets. Aside from this counsel however, *bankers did not dictate economic and financial policy but rather set the parameters for economic policy in the pre-Bank of Canada era.* After 1935, the ready access to the Deputy Minister of Finance was substantially reduced as a direct consequence of the creation of the central bank. Thereafter, the new intermediary, Governor Towers, insulated the Deputy from direct contact with the banks, a development of no small consequence. As the Department of Finance evolved from an administrative department into a high-powered, policy-making unit, Dominion economic policy gradually evolved from timid, short-term, reactive policies into longer-term, macro-economic policy programmes in such fields as export insurance, housing policy, and family allowance. This evolution towards an academic style served as a counter-poise to the Bank of Canada whose conservative orientation was much closer to market sentiment. Finance, in contrast, was more attuned to the political agenda, *viz.* unemployment, lower interest rates, inflation, bond price maintenance.

Nevertheless, the enormous market power exerted by the banks and influence of the capital markets was not entirely unchallenged. The institutional change that gave the Finance Department greater autonomy *vis-a-vis* the banks was utilized effectively during the war when the relative powers of the state and domestic finance capital shifted dramatically. Although the state did not directly involve itself in the control and regulation of financial institutions as Bob Bryce recommended, 'conscription of capital' did in fact occur against the wishes of the chartered banks through the infamous deposit certifcate. In the post-war period, the eclipse of bank influence is seen in the Government's repayment as opposed to refunding of debt, the debt democratization programme, and the central bank's intervention in the field of commercial credit. This control nevertheless remains sharply delimited by the ideological commitment of the central banker to the virtues of the *laissez-faire* market economy, free trade, and the free flow of capital

across borders.

Here, it should be again emphasized that this study covers a short span of time and embraces a period of exceptionally rapid growth of public debt and monumental institutional change. Thus, the particular relationships existing between the Canadian state *qua* debtor and its institutional creditors is unique to the period and the institutional context. It may perhaps be argued that the economic crisis provided the creditors with the capacity in the short-run to influence policy-making, but this same crisis precipitated a political debate that culminated in a dramatic transformation of the relations between state debtor and state creditors.

Investment Dealers

When compared with the mighty banks, dealers were small fry, usually at war with each other, frequently undercapitalized, and often financially dependent on their banker. Their role in capital markets was, and is, crucial since their active trading of securities makes them highly knowledgeable about market prices and the bond holdings of major institutional buyers and sellers. Whereas the banks attempted to exercise leverage with respect to price, the dealers were primarily motivated by the lure of lucrative commissions and larger allotments. As a consequence of their role as financial intermediaries, the dealers were never in a position to debate issue prices with the Government except in the negotiations of October 1930. Their attempts to improve their commission receipts were generally a failure largely due to intense competition leading to many competitive bids.

This cursory examination of the behaviour of the Investment Dealers Association supports two tenets in the literature on interest groups. First of all, there was a clear determination on the part of the I.D.A. for official recognition from the Bank of Canada as the group responsible for policing the distribution of Government of Canada securities. This recognition would enhance the prestige of the organization and allow it presumably to become more formally institutionalized. Secondly, the Association sought to control the intense and often bitter rivalry between its members over such matters as selling to institutions. This fierce competition was reduced somewhat during the war with the introduction of an exempted list of institutions which gave each dealer a pro-rata share of the total commissions.

The Influence of the Market

Perhaps the greatest obstacle to a socially optimal distribution of wealth and income in Canada is not so much the huge volume of debt held by a relatively small number of financial institutions, estates, wealthy Canadians and non-residents, but acceptance of the legitimacy of market signals by Finance ministers and their officials. Foreign and domestic market reaction to domestic political developments was premised on the understanding that the Dominion must maintain an economic environment hospitable to the fixed claims of foreign and domestic bondholders. Given the literally thousands of options available to the Canadian and foreign investor, the market was quick to discount bonds of an offending debtor but "not in any vindictive spirit." This practice was effective in constraining the monetary and fiscal policies of the Canadian state even when foreign borrowing was neglible and exchange controls were in place. In spite of the fact that Canadian borrowers could not borrow new cash in New York, the likelihood of future borrowing at higher rates was enough to deter increases in withholding taxes in 1941.

This respect and faith in the market, the belief that the market is essentially correct in its evaluations is an extremely conservative force limiting governmental action even when the central bank is nominally controlled by the national government. Put into the terms used by elite theorists, there existed an ideological confraternity shown by the key actors and this conformity is rooted in the function of capitalist commodity and financial markets. This finding complements, to some extent, studies in the field of political culture which focus upon the values and belief systems underpinning society or certain key segments of the society. Thus state indebtedness does not become a neutral device, especially when concentrated in the hands of large institutions which seek to maximize their rate of return for their clients. The drive on the part of financial institutions to maximize returns on capital sends a simple signal to government decision-makers: expropriation of capital or the increase in expenditures and deficits will result in the discounting of bonds in the secondary market. The uncritical acceptance of these rewards and penalties by governmental decison-makers provides the financial community with an important lever in disciplining governments. Indeed, one might wish to argue that the recent "contagion from the right" in party politics and policy-making is the by-product of the realization that there exist very real limits to the borrowing capacities of so-called

"welfare states". This contagion therefore illustrates the ultimate power of the market which offers the Finance Minister the choice of borrowing at usurious rates of interest (monetarism) or bringing down new fiscal measures aimed at "restoring" the viability of private enterprise (monopoly capital)[843] and redistributing income to the "creators of wealth" (supply–side economics). This lever is especially effective when the government is faced with large inherited debts and is building up new debts at an alarming rate. In the past, the influence exerted by finance capital in general was more personalistic and concentrated, to–day it is less personalistic, more diversified in its character but nonetheless pervasive in terms of the movement of capital across national borders.

International Borrowing

In *The Communist Manifesto*, Marx and Engels proclaimed that capitalist would expropriate capitalist until the internal contradictions of the wage labour system and monopoly capitalism would usher in the new socialist age. However, capitalism in evolving many different forms of ownership and control of the means of production has managed, at least to the present, to escape the death knell predictions of Marx and others. Capitalism has adapted, in part, through the creation of the joint stock company and through the money and capital markets in which ownership of plant and equipment has become part "ownership" in a corporation, public utility, or government in the form of an easily transferable paper certificate. The *threat* of outright expropriation of physical assets by national governments is now managed by the internationalization of capital through discounting bonds in metropolitan markets and the refusal to advance credits for imports, etc. While the system breaks down periodically, the seemingly inexorable drive of capital for the maximum rate of return usually results in payment to the expropriated capitalist by the host government or reimbursement of the capitalist corporation by the parent nation in the form of "expropriation insurance".

In Canada's case, foreign indebtedness, particularly to the United States and to the United Kingdom, led the Dominion to intervene decisively with Alberta to preserve its credit rating abroad. The initiatives taken by Dunning, Towers, and Clark to subordinate provincial finance to federal finance seemed to be motivated by the desire to meet the

[843]This was quite evident in Finance Minister Lalonde's most recent budget of 19 April 1983.

expectations of foreign bondholders– expectations that Canada was a safe country in which to invest capital. By satisfying these expectations, the Government believed it would enhance its credit standing and thus reduce the costs of borrowing for the Canadian taxpayer. Disallowance and the refusal to lend to Alberta were the product of a widespread perception by foreign creditors that federal and provincial government credit were virtually synonymous and that repudiation or default by one would lead to the wholesale dumping of bonds harming the credit rating of the other level of government.

In acting to preserve Canada's credit standing, that plant which must be carefully nurtured, the objective of interest rate minimization was always paramount. In order to achieve this goal, market intelligence was received from Nivisons in London, from Morgan Stanley and the "Fed" in New York. This information served as a basis for determining the best time to come to market. The timing was affected, in the main, by anticipated treasury financings and the possiblity of political events obtruding to dampen the market at the time of issue. From a practical standpoint therefore, "crowding out" was a very real phenomenon for the participants believed that there was a finite amount of cash entering the market every day and that it would be folly to enter the market at the same time as another major borrower. In monitoring these market developments carefully so as to minimize interest costs, the debt manager again was conforming to the rules of the market.

Debt placed in foreign markets did erode the Dominion's sovereignty in the sense that the government had to think twice about legislating higher withholding taxes or permitting certain provincial legislation to pass. The few examples noted indicate that the ubiquitous market, the sanctity of financial contract, and the prospect of future foreign borrowing were major impediments to state initiatives in proposing new taxes. Foreign indebtedness therefore is not a neutral economic device. The recent growth of provincial foreign borrowing to finance hydro-electric development to create temporary construction jobs and financed by the sale of cheap power to the United States gives America's capital market enormous leverage over the Canadian debtor. As Professor Stevenson noted, the New York money market seems to "have more impact on provincial policies than anything that occurs in the polling booths on election day."[844] While this is obviously putting the case too strongly, it seems intuitively reasonable to hold that the

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[844]*Unfulfilled Union*, Toronto: 1979, p. 110. See also Garth Stevenson, "The Political Economy of Canadian Federalism," in Panitch (ed.), 1977, pp. 84-86.

increasing level of foreign bonded indebtedness is a major obstacle in Canada's way of pursuing a truly independent fiscal and monetary policy.

The study also sheds some light on the validity of certain nationalists' claims that the transformation of foreign equity capital (direct ownership) into debt capital (portfolio investment) will solve many of Canada's structural problems. Debt capital it should be emphasized is a *first claim* against the assets of the Canadian economy, and therefore the distribution of the foreign debt (mostly American), will bind the debtor more closely to the economy of the creditor. Direct ownership may do this also. However, the point is that foreign indebtedness represents obligations which constrain a nation's economic independence. If these obligations can be paid off, that is one thing. Unfortunately Canada's balance of trade with the United States is usually a deficit overall which means that unless decreased borrowing coincides with a vast improvement in our trade and capital balance with the Americans, the nation will continue to mortgage its economic future in New York. Once again, the reader is cautioned that these are simply inferences based on an historical account of a set of relationships four or five decades ago. Still, as capital becomes more international, it is probable that the influence of New York, Europe and Japan's capital markets will remain problematic.

Theoretical Implications

With the specter of state insolvencies and suspension of payments portending a collapse and bail-out of the world's major banks, a re-evaluation of debt in general and public debts in particular, is timely. In the case of Alberta, other western provinces and the Dominion, economic crisis left governments vulnerable to exchange fluctuations and commodity price declines. The heavy contraction of debts at the peak of economic trade cycles by governments (a pro-cyclical fiscal policy) was falsely premised on a constantly rising national income which was the fundamental assumption in the work of Eusey Domar discussed in Chapter II. The inevitable downturn in Alberta's situation highlighted several features of state indebtedness and debt management. First of all, the contraction of long-term debt based on the assumption of a continuing rise in the price level and the national income is short-sighted and fiscally imprudent. One need only look at the fiscal policies of the present Alberta Government and many junior oil companies during the

short-lived oil boom to see the bankruptcy of such policies.

Secondly, the crisis of public finance during the Great Depression also demonstrated that domestic-pay and foreign-pay debts are indeed different. The premium paid on optional payment bonds, which became, for all intents and purposes, U.S. pay obligations in 1931, added enormously to the cost of servicing the debt- a premium which would not have been paid had those debts been denominated in Canadian funds. Alberta's predicament also underscores the consequences of unproductive state investment which created "dead weight" debt to be serviced by future generations of taxpayers with no benefits accruing to the economy in return. This leads one to the conclusion that *public debts for which no productive assets are created will inevitably lead to higher taxes to service the dead weight debt.* To be sure, continued borrowing, at ever higher rates of interest, will delay tax increases but only temporarily. In the end, taxes will go up, not come down unless the economy is growing rapidly in real terms. As Marx stated, "over-taxation is not an incident, but rather a principal." This conclusion is significant for western democracies in which "economic manipulation for political profit" around election time has become customary.

The implications of this interpretation are worrisome for a nation like Canada which over the past decade has been borrowing heavily to finance *current consumption* of resources out of current savings. A miniscule portion of federal expenditures is now spent to improve the productivity of the national economy i.e. infrastructure, with the bulk of expenditures now on civil service consumption, unemployment insurance, interest on the public debt, and medical and other social programmes- all worthy in their own right perhaps, but they do not directly improve the productivity of the national economy.[845] Though it is quite true that borrowing pays for the social services necessary to maintain social harmony and the existing distribution of financial assets in the community, it is highly doubtful that these policies can be sustained indefinitely. In James O'Connor's terms, the accumulation functions have been reconciled temporarily with the legitimation functions

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[845]See Bank of Canada, "Recent Growth in productivity, real expenditure per capita: Accounting for the differences- An Update," *Bank of Canada Review*, (July 1983), pp. 3-12. This article shows that between 1962 and 1972 productivity grew by 2.6 per cent per annum while between 1976 and 1981 real productivity declined 0.26 per cent per annum. From fiscal 1975 to fiscal 1982, the deficit as a percentage of government spending ranged between 9 and 27 per cent while the deficit as a percentage of G.N.E. ranged from two per cent to nearly eight per cent, or nearly twice that encountered in the depression of the 1930s.

through the expedient of borrowing. The continuation of this policy has given taxpayers and those citizens at the bottom end of the income scale the erroneous impression that these services are in fact being provided through the already high tax load. This is clearly not the case and the experience over the past decade shows that government expenditures on interest charges are rising while expenditures on social programmes are declining, an indication of the redistribution away from the poor to the *rentier* class.[846] While some observers on the left of the political spectrum may argue that concerns about the public debt and escalating interest charges are a manifestation of right-wing phobia, the issue must be seen in terms of the redistribution of income from "average taxpayers" back to a pampered, class of "lazy annuitants". Those who argue that social programmes can be financed indefinitely through borrowing have their head in the sand because of (1) the usual inflationary consequences, (2)the international mobility of capital which will demand ever higher rates of interest to pay for this form of deferred taxation, and (3) most importantly, the avoidance of the fundamental problem that these programmes ought to be financed through the tax system by those who can afford to pay and who derive important economic and social benefits from this form of "social harmony insurance." As Professor MacGregor expressed back in the thirties, *tax* the *rentier* class don't *borrow* from that privileged economic class.

Another dimension of the theory of debt management which comes into sharp relief from the Alberta experience is the issue of retaining flexibility. The Alberta government was hampered not only by the optional-payment bond but also by the absence of the call feature on its outstanding stock. Thus, default was the only means by which the Province could break out of the bondage imposed under the debt covenant given the bondholders' intransigence. Currently, the Federal Government's desperation for cash has led to a rapid decline in the volume of issues subject to a call provision. At at June 30, 1983, a paltry $1.7 billion of $55.4 billion of marketable, unmatured debt was callable. It is also interesting to note that roughly $10 billion of the Federal Government's outstanding marketable debt gives the lender the right to *extend* the bond at the original, contracted rate for an extra period of time making it even more difficult for the debtor to take

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[846]Recent demands in some quarters for the sale of *tax free* federal bonds is another indication of the possibility of a continuing redistribution of incomes from the poor to the very rich.

advantage of lower rates if and when they return. These two aspects of Canada's current national debt will likely come to haunt future (Conservative?) governments.

The following is a synthesis of the opposing views cited earlier on the nature of public debts and the burden of the debt.

1. Foreign-pay debts differ from domestic-pay debts and *may* leave the domestic debtor with heavy losses caused by exchange fluctuations. Those risks are eliminated when borrowing on the domestic market. Of course, the debtor may be encouraged to borrow abroad because the exchange rate and interest charges at that time are favourable.

2. Public debts contracted by a state with the ability to increase purchasing power, that is, with ultimate responsibility for the volume of currency in circulation, are fundamentally different to debts contracted by subordinate governments, corporations and individuals that do not possess this creative power.

3. Governments, even those that hold this creative power may become effectively bankrupt as a result of incurring heavy debts denominated in another currency.

4. The burden of the debt may be shifted forward in time if (1) debts are contracted at rates of interest higher than the normal market rate of interest, (2) future financial costs of the project are higher than the future stream of benefits discounted at an appropriate rate, and (3) the investments turn out to be unproductive leaving a dead weight debt. This burden will be disguised during a period of growth in real national income.

The Alberta Aberration

The exploration of Alberta's default served to emphasize the thorny problems associated with a rigid debt structure and the implications for the Dominion's behaviour *vis-a-vis* domestic creditors and the international financial community. The crisis demonstrated that the Dominion, motivated by self interest in regard to the re-financing of hundreds of millions of maturing bonds, successfully isolated the Social Credit administration. It did so by refusing to sanction Alberta's proposed interest reduction scheme on municipal and provincial debts and by pressing Alberta to agree to a Loan Council. Through these public initiatives, Dunning was able to convince foreign capital, which previously regarded federal and provincial credit as synonymous, that Alberta was a special case, a poor cousin whose actions were in no way supported by the Dominion.

The default also served to build a close working relationship between the Dominion and the chartered banks during the early years of Towers' tenure. This close co-operation preserved the constitutional authority of the Dominion in the sphere of banking, credit, currency and interest. Moreover, this alliance confirms earlier studies of Canadian interest group behaviour which show that interest groups will focus their main

efforts at the level of government constitutionally charged with regulation of their own economic activity.

One other point bears mention. Prior to the victory of the Social Credit, the U.F.A. government desperately sought financial assistance from the central bank and the Dominion to underwrite a road-building (re-election) programme. The result of these deliberations was the signing of a loan agreement with the Imperial Bank hypothecating future revenues in exchange for a $1.5 million loan; the hypothecation also to cover a previous advance. This transaction reveals the financially bankrupt position of the Province and the enhanced power of the creditor to demand greater guarantees of security from the borrower. Lacking the ability of the Dominion Government to sell its debt to a central bank, the provinces found themselves in a jam when dealing with the chartered banks. It would be interesting to explore these transactions further in other provinces to see if, in fact, the provinces were being squeezed by the banks.[847]

Suggestions for Further Study

This study was initially concerned with the problematic of increased indebtedness threatening the sovereignty of the state. What emerged was a description of the factors leading to the evolution of new institutions concerned with government debt management as well as economic policy-making. The findings of this study can be extended in several directions beyond the narrow scope of Canada, Canadian interest groups, and its governmental machinery.

In examining the behaviour of the chartered banks evidence has been presented which lends credence to the thesis that the constitutional division of powers is an important determinant of interest group behaviour. The examination also shows the critical role performed by the CBA as a conduit funnelling political information in the "Montreal" and "Toronto" General Managers and in managing the banks' relations with the government. This intermediary role performed by the Secretary and President of the Association is especially crucial during the Bank Act revision period and when major challenges confront the banking system as occurred in 1935-1940. Obviously more

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[847]This is definitely hinted at in the "Memorandum prepared by Special Western Interprovincial Committee for the Royal Commission on Banking and Currency," August 1933.

research is required before specific hypotheses may be advanced about this particular lobby group. That no interest group study has ever been done on the CBA is a sad testament to the relevance of political science in Canada to-day. Another suggested area for further research would be on the role and function of the Investment Dealers Association. Unfortunately few records have survived over the years. What may be of particular interest would be the struggle over jurisdiction which has been raging between the banks and the dealers and the financial services industry in general over the decades. Related to this need for an improved understanding of financial institutions and their associations would be a study of the nature and structure of the life insurance and trust company industry both historically and through to the present time.

A second area of study would involve the gathering of data on provincial government borrowing. This comparative survey might consist of a quantitative analysis assessing the financial and economic factors affecting a province's credit rating. Any anomalies which could not be explained by the usual economic and financial factors indicate that other factors, possibly political factors, are at work. For example, credit ratings may be affected by the type of government in power– conservative, separatist, or social democratic. Such studies could also be carried out across nations ensuring that the governments compared generally exhibit the same broad political and economic characteristics.

And finally, class analysis may offer a useful model for interpreting the politics of government borrowing. If suitable information were available on the distribution of debt over time, it might be possible to make better inferences about the influence of institutions such as life insurance companies on government policies. Furthermore, such a study could aid in comprehending more fully the role of financial trustees and intermediaries in the economy and their relationship to the state.

Concluding Observations

After exploring the politics of debt management for the 1930 to 1952 period, some striking parallels with to-day's developments stand out. These parallels include the wild speculation that took hold in oil stocks, precious metals, and real estate in the late 1970s, the recent "global banking crisis", a well-established contraction of commercial

credit and the purchase of large amounts of government bonds by the Canadian banks.[848] As was the case in the 1930s, the international banking system remains woefully unregulated and large profits banks have declared (and very large risks assumed from debtor countries) are again subject to heated criticism at a time when the rest of the economy is suffering from underproduction, heavy corporate losses, and high levels of unemployment. Typically, the C.B.A. has launched another round of advertising to convince skeptical Canadians that commercial banking is indeed competitive, profits are not "excessive", and that banks perform an important "social function".

In this context, debt once again has come to be seen as a mixed blessing. External indebtedness in light of the fall in the Canadian dollar becomes hazardous for a nation that consistently runs a large capital and trade deficit with its main creditor and that apparently is incapable of remedying its structural problems. These problems, in turn, stem from a policy of heavy borrowing to finance imports of American manufactured goods and a high Canadian dollar which discourages import substitution and export development in the manufacturing sector.

Perhaps the most important aspect of the study is that it identifies the function of the market in disciplining the political behaviour of provincial and federal governments. If the state is indeed a captive, it is not so much a captive of special interests but a captive to the musings of the capital markets in which its instruments are the principal commodity traded. The great tragedy of debt management to-day is that the goal of interest cost minimization has been subordinated to a policy of high interest rates set in the United States. Moreover, there is some evidence already accumulating suggesting that the Federal Government is in the position of a debtor which must offer more and more inducements to the investor classes to ensure the success of its marketing efforts e.g. tax free bonds, extendibles, non-callable bonds. In short, *the more one goes to market, the more one must listen to the market and respect the market's judgment.*

We may be reasonably certain therefore that growing indebtedness will give the institutional creditor at both the provincial and federal level greater influence over decision-making with the possibility of even harsher measures to increase taxes on wage

[848] See Bank of Canada, "Weekly Financial Statistics," (Ottawa: 18 August 1983), Table 5, pp. 2-3. Between August 1982 and August 1983, "general loans" dropped by $11.0 billion while holdings of federal government paper rose by some $8.4 billion. Total Canadian assets of the banking system fell a modest $1.640 billion during the year.

and salary incomes, measures to increase regressive taxes on alcohol and cigarettes alongside new tax incentives to those deriving their income from capital. In these uncertain economic times, the government will likely support orthodox measures as did Bennett's Conservatives. In the medium term, it is probable that these remedies will prove to be politically unacceptable and there may evolve new *institutional* mechanisms to once again take tighter control of the capital markets to lessen the financial community's influence over markets and economic policy–making.

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APPENDIX A. Legal, Institutional and Technical Background

Legal and Administrative Procedures

Under sub-head 91(4) of the *British North American Act, 1867*, Parliament is authorized to borrow "Money on the Public Credit." Sub-head 91(1A) makes Parliament responsible for the "Public Debt." This Act also granted the Dominion Parliament explicit and exclusive authority with respect to the chartering of banks and savings banks, currency and coinage, interest and legal tender.

The *Exchequer and Audit Act*[849] and its successor act the *Consolidated Revenue and Audit Act, 1931*[850] deal directly with the debt management function. Section 6 authorized the Governor-in-Council to appoint a fiscal agent to negotiate loans on the Dominion's behalf, to pay interest on the public debt, to manage sinking funds, and to perform other duties normally associated with the fiscal agency function. Section 7 of the Act permitted the Governor in Council, subject to the terms of the enabling loan act, to issue a variety of securities- debentures, stock, terminable annuities, exchequer bills or bonds at rates *not exceeding six per cent per annum.* The interest ceiling stipulation accords with provisions of the *Interest Act* and *Bank Act* which set limits on the rate of *interest* to be legally charged on loans. Section 7(a) authorized payment of interest from the Consolidated Revenue Fund, the Dominion's bank account. Section 8 provided for the establishment of sinking funds whose annual purchases could not exceed one-half of one per cent of the total securities outstanding to which the fund related. The main purpose of sinking funds is to reduce the amount of principal to be repaid at maturity. Sinking funds are most frequently observed in the debt management operations of local government boards, corporations, and utilities. Sections 9, 10, and 11 dealt with the inscription and the registration of the securities. Section 13 permitted the Governor in Council to change the form of the funded debt so long as the principal and annual interest thereon remained the same or was reduced. This allowed refunding at lower rates without recourse to Parliament.

In the event of unforeseen circumstances, a provision was made authorizing the Cabinet to borrow sums for periods not exceeding six months at rates of interest not to

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[849] Revised Statutes of Canada, 1906, Chapter 24.
[850] 21-22 George V, Statutes of Canada, 1931, Chapter 23.

exceed seven per cent. The amount so raised could not exceed the deficiencies in the Consolidated Revenue Fund. The Governor in Council was required to present the details of the borrowing to the Commons within fifteen days of the opening of the new session.

Section 16 made the Deputy Minister of Finance responsible for maintaining a record and description of all securities issued showing the date of issue, date interest was paid, redemption period, and cancellation of securities. The Deputy Finance Minister in fact shared the responsibility of examining and cancelling securities with the Auditor General(Section 18).

The borrowing procedure under this framework begins with passage of a loan act authorizing a *maximum* sum to be borrowed. After negotiations between the government's fiscal agent (prior to 1935 the Bank of Montreal) and a banking syndicate or group of primary distributors was completed, a recommendation to the Governor in Council by the Finance Minister was drawn up. This order–in–council specified the loan act under which funds were to be borrowed and the terms, conditions and amount of the loan. Usually the price was not entered until the last moment as 'breaks' in the market could jeopardize the marketing of the issue, leaving dealers holding the bag so to speak.[851] An example of an abrupt break in the market occurred on 21 September 1931 when the United Kingdom went off the gold standard sending bond prices plummeting.

On March 10, 1935 the Bank of Canada commenced business taking over the role of fiscal agent functioning in this capacity *without remuneration*. Section 23 of the *Bank of Canada Act* named the central bank as "manager of the public debt."[852] Before 1935 the Government dealt *directly* with a banking syndicate put together by the Bank of Montreal; after 1935 the Government worked through an *intermediary*, the Bank of Canada. In New York, the venerable investment firm Morgan Stanley was apppointed lead manager and fiscal advisor to the Dominion of Canada sometime in 1937 while in London, the Bank of Montreal remained the Dominion's "paying agent".

Under Section 21, of the *Bank of Canada Act* the Bank's investment powers were specified. While the Bank's investment powers were considerable, in practice, the Bank held and traded Dominion government securities primarily. It was the daily market contact

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[851] Testimony of W.C. Pitfield, *Proceedings*, Royal Commission on Banking and Currency, Toronto, 11 September 1933, pp. 3094–3095.
[852] 24–25 George V, Statutes of Canada, 1934, Chapter 43. See section below "Marketing the Public Debt."

which also enabled the Government to gather for the first time relevant market information from its fiscal agent, an agent charged with "regulating currency and credit in the interest of the nation" and not a particular group of shareholders. As an active participant in the market, the Bank was able to provide the Government with vital market information. To paraphrase a former Finance Department official, "in order to know the market one must be actively in the market."[853] In some sense this is akin to the "window on the industry" argument used to rationalize the creation of Petro-Canada. The Bank also provided the Government with vastly improved statistical information on bond prices, yields, new issues, exchange rates, etc.

In 1951, the *Financial Administration Act* was passed.[854] Under the previous legislative framework, *all* borrowing was to be authorized by Parliament, while the 1951 Act provided Cabinet considerable latitude with respect to *maturing* debts. Section 43 authorized the Governor in Council "to borrow such sums of money as are required for the payment of any securities that were issued under the authority of Parliament, other than section fourty-four, and are maturing or have been called for redemption." This was actually routinizing a precedent established with the passage of the *Appropriation Act, No. 1, 1947* which authorized borrowing to redeem issues maturing in fiscal 1947-1948. [855] The effect of this change was to facilitate the administration of state borrowing by removing from the parliamentary arena the *opportunity* to debate whether or not loans should be repaid or merely turned over.

Debt Instruments

A debt instrument represents a promise by a debtor to pay to a creditor an agreed upon series of interest payments and principal at specified dates. In exchange for the funds advanced, the debtor provides a certificate of indebtedness held for safekeeping by the debtor until the redemption or cancellation of the debt. Government *debentures*, commonly known as bonds or government paper, are certificates of indebtedness *against which no specific assets are pledged*.[856] These debentures may be classified according to

1. term to maturity or liquidity,
2. currency or specie in which the interest and principal payments are denominated,

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[853] *Interview* 11 June 1982.
[854] 15-16 George VI, Statutes of Canada, 1951, Chapter 12.
[855] 11 George VI, Statutes of Canada, 1947, Chapter 1, section 6.
[856] In this study the terms government "security", "stock", "obligation", "debenture", "bond", "paper", and "debt instrument" will be used interchangeably.

3. their marketability, and
4. the manner by which these debentures or securities are sold– by auction, private or public placement.

Debt instruments maturing within three years are usually termed short–term assets. Both the central bank and the chartered banks are big players in this "money market" (discussed below). By far the most important short term security is the *Treasury Bill* or 't–bill'. Treasury bills were originally issued during World War I but were first issued on a routine basis fortnightly in August 1934, several months before the central bank began operations. Buying and selling bills by the central bank has a crucial effect on the liquidity in the banking system, that is, the control of the money supply. Treasury bills are now *auctioned* every week to the highest bidder unlike other instruments that are sold at a specific price.[857] Bills are bought at a discount, below par, and are redeemed on maturity at par. Maturity dates usually range from 91 days to 182 although one–year bills are not uncommon.[858] Before the involvement of investment dealers in 1953 with the establishment of a purchase and resale agreements with the central bank, all bills were held entirely within the banking system.[859] In this period the normal practice of the banks was to hold these very low yielding securities (0.5 to 1.5 per cent) to maturity.

Mention must also be made of *optional-payment* bonds.[860] The optional payment feature was a rather unique inducement to investors and the perfect hedge against currency fluctuations for it permitted the holder to ask for interest and principal payments in a currency then trading at a premium. Although Dominion optional–pay issues were quite rare and were retired early in the period under consideration, many two or three pay bonds were issued by the Canadian National Railways, by municipal and by provincial governments. Such instruments made these borrowers especially vulnerable when the Canadian dollar took a beating after Britain went off the gold standard in September 1931. Because of their nature it was difficult to determine the nationality of the holders. Hackett

[857] See "Government of Canada Treasury Bills," *Bank of Canada Review*, (May 1972), pp. 3–13. For an account of the characteristics and functions of the British treasury bill see G.A. Fletcher's *The Discount Houses in London*, (London and Toronto: 1976), pp. 113–127.

[858] In 1953, the Bank of Canada replaced the fortnightly auction of bills with a weekly auction and introduced a 273 day treasury bill. A recent development has seen the auction of two year bonds to dealers and banks.

[859] According to A.F.W. Plumptre some foreign money was invested in these bills in the 1930s. *Central Banking in the Dominions*, (Toronto: 1940), p. 141.

[860] W.T.G. Hackett, "Canada's Optional Payment Bonds," *Canadian Journal of Economics and Political Science*, Volume 1, No. 2 (May 1935), pp. 161–170 and Plumptre, 1940, p. 232.

calculated that a considerable volume of these bonds had been domiciled in Canada by the mid-thirties.

Some bonds, including the 5 1/2 per cent Victory Loan 1918-33 and the 5 1/2 per cent Victory Loan 1917-37 carried a covenant exempting the holder from Dominion taxation. This feature made these bonds exceptionally attractive to estates, wealthy individuals and financial corporations. During the conversion operations in the 1930s the Government found it difficult to induce holders to convert these high yielding, tax-free securities for lower yielding, taxable securities despite a premium.[861] In the United States municipal and state bonds are exempt from federal taxes which allow these governments to borrow at lower rates.

Another feature of a debenture, whose absence hampered the Government in their conversion operations, is the "call feature". Call features, vigorously resisted by investors, permitted the borrower, at a specified date in the future, to "call" the bonds for redemption. If, in the interim, bond prices rise (yields or interest rates fall) it is to the advantage of the borrower to call these bonds for redemption and to re-finance at lower rates. Examples of bonds with a call feature issued during the war include the 3 per cent War Loan Bonds issued in October 1940, maturing in 1952 and callable in 1949 and the 3 per cent Third Victory Loan of November 1942 maturing in 1956 and callable in 1953. A similar feature though working to the advantage of the buyer, is known as an *extendible*. The holder of an extendible may elect to extend the term to maturity before a certain date. This means the holder will extend the term of the bond should interest rates fall in the interim. This feature was added as a "sweetener", an inducement to investors who were reluctant to buy long-term bonds during the 1979 to 1982 period. At present there are approximately 10 billion dollars of extendibles outstanding "maturing" between 1982 and 1987. One such issue are the "13s"issued in May 1980 and exchangeable on or before 1 February 1985 at par into 13 per cent bonds maturing May 1, 1990. However, heavy reliance on extendible financing may cripple refinancing efforts when interest rates fall.

Some guaranteed bonds of the Dominion issued by the Canadian National Railway Company were *gold bonds*. The holder of a gold bond was therefore entitled to

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[861]Prime Minister Bennett in replying to Mackenzie King's query about the Government's policy on tax-exempt bonds declared "the non-taxable feature of old bonds cannot be abrogated- but none of the new bonds are free from taxation. House of Commons, *Debates*, 17th Parliament, 2nd Session, 8 May 1931, p. 1383.

repayment of principal in gold. With the passage of the *Gold Clauses Act, 1937* repayment of obligations in gold was "declared to be contrary to the public interest."[862]

Deposit Certificates were sold to chartered banks during the Second World War. These certificates yielding very low rates of interest (.62-1.75%) were sold for six month terms. Slightly over one billion dollars of 'DCs' were outstanding in 1946. As discussed in Chapter VI, their illiquid nature and low yield made the banks unhappy for they were effectively tied to loaning the government funds at or below cost. *Treasury notes* are another security sold by the government to the central bank and to American investors in the 1930s and 1940s. Essentially a government debenture with a different label, these notes yielded a market rate of interest over a one to five year period.[863]

Perpetuals, known as "consols" in Great Britain, are direct government obligations *with no fixed maturity date*, hence the name perpetual. Put differently, perpetuals are securities on which the principal will theoretically never be returned to the holder. During the period under study, one issue of $55,000,000 perpetuals was sold in September 1936 to yield the holder 3.11 per cent. These securities were callable in 1966 and eventually redeemed in 1975.

With the exception of deposit certificates, the foregoing securities are easily marketable.[864] "Canadas" are readily marketable for tworeasons: firstly, there is a large volume of bonds outstanding and secondly government obligations are the safest or most secure form of debt. Another form of debt is the *non-marketable* Canada Savings Bonds or War Savings Certificates. These savings instruments cannot be sold or transfered to another individual nor can they be held as collateral by lending institutions. Sold only to individuals and estates up to a specified annual limit, they are cashable on demand.[865] Introduced in the autumn of 1946 as a means of maintaining the sales organization established during the Victory Loan campaigns, these "tap loans" lasted a full year (from autumn to the next autumn campaign). To-day there is an all-out month long campaign.

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[862] 1 George VI, Statutes of Canada, 1937, Chapter 33. Very soon after Britain went off the gold standard all domestic Canadian gold-pay debts were suspended. P.C. 2617, 19 October 1931.

[863] For example the 2 year, 4 % notes maturing 1 December 1934 and the 15 month 4% notes payable in New York due 1 October 1934, and the 2 1/2 year, 1.5% notes 1941-43 held by the Bank.

[864] See Bank of Canada reprint: "Government of Canada direct marketable bonds," *Bank of Canada Review*, (May 1980).

[865] See "Canada Savings Bonds," *Bank of Canada Review*, (October 1977), pp. 22-31.

Since 1966 a number of innovations have been introduced including compound interest, bonus payments, payment by cheque or bank deposit and the re-adjustment of rates which occurred twice in 1981.

The Capital Market

> It is not from the benevolence of the butcher, the brewer, or the baker that we expect our dinner, but from their regard to their own interest. We address ourselves, not to their humanity but to their self-love, and never talk to them of our own necessities but of their advantages.
>
> Adam Smith[866]

A *capital market* may be decomposed into various sub-markets based on the term to maturity of the instruments traded or the "life-cycle" of the security traded. William C. Hood in his study *Financing of Economic Activity in Canada* defined the capital market "as the set of contacts between buyers and sellers who effect exchanges involving *non-monetary financial assets.* In other words, considering that all exchanges are effected "in markets", we shall say that exchanges involving non-monetary assets take place 'in the capital market'."[867] The origins of Canada's capital market may be traced to the emergence of brokers (financial intermediaries) in Montreal and Toronto in the 1840s. In 1863 a Board of Brokers was formed in Montreal. However, the main impetus for a capital market came during World War I and the heavy financial requirements of the Dominion which had previously done virtually all of its borrowing on the London market.[868]

The *money market* is a structured set of financial relationships between buyers and sellers of debt instruments with a term to maturity of *less than three years.* More specifically:

> the money market embraces the various arrangements by which (1) most *non-equity* fixed income securities maturing within three years are issued, traded and redeemed, (2) short-term funds are borrowed and lent on the security of these obligations *on an impersonal basis.*[869]

The initial impetus for a sensitive, broadly based, money market came with the creation of the Bank of Canada. Previously the chartered banks' money market activities were

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[866] *An Inquiry into the Nature and Causes of the Wealth of Nations,* (Harmondsworth: 1970), p. 119.
[867] Hood, 1958, p. 11. (emphasis added)
[868] E.P. Neufeld, *The Financial System of Canada,* (Toronto: 1972), pp. 468-472, 501-507. Remarkably only $800,000 in Canadian pay bonds were outstanding in 1914.
[869] S. Sarpkaya, *The Money Market in Canada*, Second Edition, (Toronto: 1980), p. 3. (emphasis added)

confined to New York's call loan market. The establishment of an efficient money market was essential from the perspective of the central bank because it meant a more rigorous and optimal employment of capital, and the setting of interest rates with more precision. In reviewing post-war monetary policy before a House of Commons Committee, Graham Towers remarked:

> A broad and responsive market in Government of Canada securities and the existence of the machinery which makes such a market possible helps to develop a better market for other securities and to channel funds where they are needed for the development of the country.[870]

Before the introduction of a money market in 1953 the principal instrument for trading, the treasury bill was held by the banking system. At the end of 1952 only $30 million of $450 million in outstanding bills was held outside the banking system. The Bank's entry into purchase and resale agreements with the principal investment dealers in 1953 enabled the latter to take into inventory (a "long position") large holdings of government bills.[871] Shortly after these arrangements were instituted the chartered banks began to make day-to-day loans to dealers under which securities held under purchase and resale agreements were pledged as collateral.

In Canada the capital and money markets are contiguous as there are no legal impediments segregating these financial markets. Unlike stock exchanges where the visitor can watch transactions consummated at the various "trading posts" on the exchange's floor, capital markets are not located in one central place. Instead debt instruments are traded in an "over-the-counter" or "between-dealer" market. This market consists of a system of telephone and telex interconnections between the "bond desks" of chartered banks and investment dealers. Those telephone connections are used by traders to determine the availability, price, and denominations of specific bonds. After making inquiries on "the street", a bond trader will then make a bid (purchase) or offering (sale) "firm". Any disputes between traders, which are rare, are referred to the Bond Dealers Association of Montreal or Toronto whose rules on trading and bond delivery are established by the Investment Dealers Association of Canada. It is interesting to note that

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[870] "Review of Post-War Monetary Policy," in E.P. Neufeld, (ed.), *Money and Banking in Canada*, (Toronto: 1964), p. 274.

[871] "Government of Canada Treasury Bills," *Bank of Canada Review*, (May 1972), pp. 3-13 and Bruce Maclaury, *The Canadian Money Market: Development and Impact*, Harvard University, Department of Economics, unpublished Ph.D Dissertation, 1961.

Canada's largest dollar volume market remains largely unregulated. To be sure, the omnipresent Bank of Canada plays a key role in disciplining or discouraging certain practices of dealers and banks.

The *primary market* constitutes the original distribution of an issuer's debt. The term is derived from "primary distribution"– the initial distribution of the borrower's securities. The period immediately following the primary market is known as the *after-market*. This is a very critical time for the issuer and debt manager, as advisor, revealing for the first time the market's evaluation of the security's price. Securities that are over-priced trade at a heavy discount while those under-priced trade at a substantial premium. The issuer usually looks for a moderate premium over the issue price to consider the pricing satisfactory. Technically speaking, the after market in "Canadas" commences when the Bank lifts its restrictions on pricing, normally a week to ten days after primary distribution is completed.

The *secondary market* consists simply of trading fixed-income financial instruments, including instruments which may be discounted such as treasury bills, previously distributed. In other words, the secondary market in government paper represents the existing stock of debt sold and in the hands of the public. Once the debt has been sold there is nothing holders can do to exercise leverage on the borrower. Still, when bonds are sold in large volume, the impact on prices will send a message to the debt managers as prices in this market for particular securities determine, in the main, the pricing decisions for future issues. For instance if the Government is contemplating an issue of thirty year bonds, the price is normally based on the price of Canada bonds trading in the secondary market and maturing in thirty years. According to the Royal Commission on Banking and Finance the secondary market "by enhancing the transferability of securities and serving as a guide to values, makes the primary new issue market a larger and lower-cost market than it would be in the absence of such after trading."[872] Bond pricing will also depend on the "tone" of the market. If uncertainty exists with respect to the direction of interest rates (yields), monetary policy, and the government's fiscal stance, sudden breaks might occur in the market as institutions "hedging" against an uncertain future may precipitate a sell-off of long-term debt for instance.

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[872]Royal Commission on Banking and Finance, *Report*, p. 315.

Relations between the central bank and the dealers are sometimes strained when the latter attempt to read trends into the Bank's open market operations or are frustrated by the Bank's secrecy.[873] In the words of the Porter Commission:

> Some frustration is inevitable in any relationship between the central bank and securities markets, especially since the monetary authorities cannot always disclose their hand, even when they are certain of their future policy. In fact central bankers are often not exactly certain about underlying economic forces or what state of credit conditions is appropriate to them. Moreover, they must frequently use trial and error methods– known in central banking as "successive approximation"– until financial markets give them more guidance or the results of their previous policies become somewhat clearer. However, we believe that secrecy can be overdone, and the benefits of frank and full information are sometimes not fully appreciated by Canadian authorities. [874]

Marketing the Public Debt

Before the Bank of Canada was created, domestic issues were arranged by a banking syndicate put together by the Bank of Montreal. The Banking Syndicate would normally be composed of the major banks and investment houses who would advance funds to the Government when the securities were delivered for distribution. This function is also known as *underwriting.* The syndicate was also responsible for the preparation of a prospectus– a legal document describing the nature of the securities being offered to the public. Advertising of the issue was usually the responsibility of the distribution group, although beginning with the 1931 Conversion Loan the Minister of Finance took some initiative in advertising. Gradually there evolved more government sponsorship of advertising these issues, especially for the conversion and Victory Loans. The banking syndicate would then sell to a *distributing or selling group*– dealers, banks, and brokers the securities at a price above that paid to the government.[875] Dealers, banks, and brokers would then sell bonds to their clients and take some of the bonds into their own inventory. The allotment by the banking group was a matter of intense debate for dealers and brokers who could not satisfy their initial orders were forced to purchase bonds in the after–market, often at a premium all the while being committed to deliver these bonds to the investor at the stipulated price. A favourable allotment was therefore crucial for the distribution profits of dealers and brokers.

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[873]See Fullerton, p. 110 who succintly states: "Since the Bank often has the power to make its own forecasts come true, the dealer usually listens attentively."
[874]Royal Commission on Banking and Finance, *Report*, p. 325.
[875]A broker is a financial intermediary who buys bonds for sale to clients but does not take up an inventory position. A dealer acting as a *principal* buys bonds for the firm's inventory.

The entrance of the Bank of Canada changed the relationship between the debtor and the banking syndicate. No "negotiations" took place although informal consultations between the Governor, his officials and the financial community were frequent. One of the very first tasks of the new central bank was to reorganize the procedures for Dominion offerings. What evolved was the offering of a certain amount of the bonds "firm" to primary distributors on the Bank's list of authorized distributors. Applications accepting the bonds "firm" and requests for additional bonds were to be accompanied by a five per cent margin deposit. The final allotment was done on a pro-rata basis and was influenced by the "placing power" or distribution record of the distributors. Commissions were established by the Bank and price restrictions placed on the during during the primary distribution phase.

It is also important to distinguish between a *public offering* or *public placement* and a *private offering* or *private placement*. The former involves an offering through an underwriting group of bonds to the public. This procedure ensures as wide as distribution as possible. In New York, for instance, Morgan Stanley as the lead underwriter was capable of involving well over 400 insurance companies, investment bankers, and banks in the distribution of a Canada issue. This procedure while requiring a considerable expenditure of marketing energies meant the bonds would be widely held. The second procedure, the private placement, would involve a small group of institutional investors negotiating directly with the borrower or agent over terms of the loan. The advantages for the borrower was that the preparation of a formal prospectus was not required and the negotiations could be finalized relatively quickly. However the lenders, in expediting the loan, usually demanded a rate of interest above that prevailing in the secondary market.

Reasons for Trading

<u>Buying</u>. The main attraction of Canada bonds are their secure nature, they are ready cash. Further, reserve requirements under the Bank Act and various provincial and federal statutes governing the investments of life and trust companies compell these institutions to hold some Canada bonds. The demand for these debt instruments varies, in the main, on the evaluation of alternative yields from other investments and the safety of principal desired or security. During the last depression, the Banks moved very heavily into government bonds liquidating much of their commercial loan portfolio. In the early

post-war period both banks and life insurance companies anxiously sought buyers of their securities to write higher yielding commercial loans and mortgages. [876]

Government bonds trading at a discount (below par) are also purchased by wealthy Canadians for the yield is higher than the coupon rate and capital gains, non-taxable during the period, were realized upon maturity. The few tax-exempt bonds in the period gravitated to wealthy individuals, estates and corporations and were actively sought after.

Selling. The supply of bonds on the secondary market is associated with the fiscal position of the government (deficits increasing the stock of debt) and the volume of bonds already outstanding. Also important in the supply side equation is the demand for credit by agriculture, industry, consumers, and commerce. When demand for credit is high this will mean the liquidation of bond holdings and the creation of loans with a higher yield to the creditor institution. A second reason for disposition is the profit motive. Should interest rates fall, bond prices rise and a company or individual may wish to dispose of some bonds in order to realize capital gains which would be reported to shareholders as income. Thirdly, securities whose term to maturity does not match the firm's liabilities, will be sold or swapped for bonds with a different term to maturity. And finally, if short-term interest rates rise dramatically in relation to long-term rates some companies will readjust their liquidity preference to take advantage of this change in bond yields.[877]

Lastly it must be remembered that investment dealers have an important stake in the active trading of these bonds as they are the recipients of commissions primarily from the life insurance and trust industry. In "making a market" for government bonds they are also responsible for the initial distribution and for maintaining adequate bond inventories to meet the requirements of the large institutional investors (banks, life insurers and trust companies). This function is known as "jobbing".

Evaluation of Government Securities

The major reasons for holdings government stock are (1) liquidity, (2) marketability, (3) security, and (4) yield. *Liquidity* refers to the time between the purchase of the

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[876]See Graham F. Towers, "Post-War Monetary Policy," in James P. Cairns and H.H. Binhammer (eds.), *Canadian Banking and Monetary Policy*, (Toronto: 1965), p. 198.
[877] In his testimony before the Porter Commission, J.T. Bryden of the Canadian Life Insurance Officers Association stated that when short-term rates rise, companies often trade in their "longs" for short-term bonds though the insurance companies still remained most receptive to the long end of the market. *Proceedings*, Royal Commission on Banking and Finance, Volume 24, Ottawa, 9 July 1962, pp. 2594-2596.

instrument and its maturity date. Near–liquid instruments will mature very shortly and therefore are regarded as "near–cash". Banks and investment dealers whose major liablities are realizable on short notice e.g. demand and notice deposits, have a liquidity preference for short–term assets like treasury and commercial bills. Trust and life insurance companies whose liabilities are long–term in nature (investment certificates, debentures, and annuities) prefer to hold bonds with a term to maturity of five years or longer.

Marketability is the ease with which the bond–holder may buy or sell a security. Widely held bonds in large quantities are readily marketable while bonds which have not been sold in large quantities and are narrowly held, say by a few life insurance companies, will be more difficult to buy or sell. "Canadas" are by far the most marketable debt instrument. Marketability for any financial institution is a crucial consideration when some assets must be converted into cash on short notice.

Security and risk are inversely related: the greater the risk the less secure the investment and the greater the security the less risk to the investor. The highest quality, "gilt–edged" security traded is, of course, the paper issued by the federal government, the government which owns the central bank. Here the safety of principal and interest is secure for ownership of the central bank guarantees that the Government will always be able to meet the interest and principal requirements on domestically denominated debt as this government agency prints the legal tender notes. Security of investment is dependent on many other factors which will be elaborated on below.

Finally *yield* represents the return to the security holder and is a variable which is to be maximized in relation to security, marketability and liquidity requirements. Basically the portfolio manager of a financial institution will trade off liquidity and security for yield within certain, usually fixed limits. Yield can be improved by purchasing longer–term debt instruments and holding securities which are not high quality issues– for instance holding the bonds of Dome Petroleum or Turbo Resources which have high yields but there is the risk of default. Yield therefore depends on the term and the financial community's initial evaluation of the risk during negotiations leading up to primary distribution and the secondary market's assessment of the ability of the borrower to meet these fixed charges by offering these bonds at a premium or a discount.

The following questions are normally asked when evaluating the quality of an government issuer's debt instruments.[878]

1. Is the borrower in default on any of its *outstanding* obligations?

   This would be the first question asked before any investment or underwriting would occur. Default effectively cuts the borrower off from the capital markets on which its securities in default are traded. Although bonds in default do trade at a heavy discount (as did Alberta bonds in the late 1930s and early 1940s), the risk that interest and principal payments will remain in default makes the purchase of such bonds more of a speculative enterprise. Default prohibits the borrower from raising new capital until this position is cleared up.

2. How will the loan be repaid?

   In assessing this factor bond rating agencies such as Moody's and Standard and Poor's[879] place considerable emphasis on the constitutional powers possessed by the borrower. Thus, provincial governments which are limited to "direct taxation" under section 92(2) have less fiscal capacity to meet debt payments than the federal government with powers to raise "money by any mode or system of taxation".[880] Of further interest to investors and credit analysts are the existence of subsidies, constitutionally or statutorially enshrined, granting subordinate (coordinate?) governments some claims on the financial resources of another government. The presence of stabilization or equalization regimes makes the risk of lending to states with a poorly diversified economy much less. Finally, the government with *de facto* control of the printing press, will always command a higher credit rating than governments which do not possess this capacity. Hence, Canada's credit rating will always be higher than Ontario's despite evidence of fiscal and monetary mismanagement by the senior level of government.

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[878]This exposition is partially based on the article by Thomas Bradshaw, "Maintenance of public credit and its relation to the present financial position of many Ontario municipalities," *Canadian Chartered Accountant*, Volume 26, No. 2 (February 1935), p. 120. Bradshaw identifies the record of the borrower, security for loan, the ability to repay, and the purpose of the loan as factors affecting the investor's evaluation. A similar list was provided the author during an interview with a Toronto investment dealer.

[879]The Canadian bond rating agencies, Canadian Bond Rating Service (Toronto) and the Dominion Bond Rating Service (Montreal) did not, until just recently, evaluate Canadian government bonds– only corporate debentures.

[880]Section 125 of the B.N.A. Act which states no lands or property belonging to Canada or any Province shall be liable to taxation" is one important exception to the traditional, though mistaken view that Ottawa has "unlimited taxing authority."

A second factor relates to the economic base of the borrowing state. A resource based economy, with little in the way of a manufacturing base, is especially vulnerable when the price of its staple export falls internationally. Since taxes are assessed on corporate and individual incomes and the dollar volume of commercial business, falling commodity prices shrink the fiscal capacity of the state quite dramatically. This economic weakness was painfully apparent during the 1920s and 1930s in Western Canada when buoyant wheat prices led to an unwarranted expansion of private and public sector borrowing. The deflation of 1930 triggered a major contraction of credit leaving the three western provinces financially embarrassed.[881] Those states naturally favoured are ones with a substantial manufacturing industry, a large urban salariat, with substantial public expenditures which provide a cushion against economic downturns. The Province of Ontario with a large mining, forestry, agriculture, pulp and paper, manufacturing and financial sector therefore can borrow at rates considerably below that of the Atlantic provinces who are reliant on one or two staple products and the generosity of Ottawa.

3. <u>What is the existing debt load?</u>

Most financial information analyzed by Moody's and other credit-rating agencies concerns the present size of the debt, both direct and guaranteed. These figures however tell the analyst little about the financial health of the government unless standardized in the form of per capita debt or interest and debt as a percentage of national income. Debt and interest payments as a proportion of income are frequently used, for the total income represents the base from which the state derives its tax revenues. Relatively high interest expenditures as a portion of income and as a portion of the state's total expenditures are signs of future difficulties. Rising debt ratios need not, in all cases signify a deteriorating or dangerous financial situation. It is recognized that during some phases of economic development infrastructural investments, for example, will be required which will distort the debt picture. Still, over-optimistic expectations based upon unwarranted assumptions of

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[881]See W.A. Mackintosh, *The Economic Background of Dominion-Provincial Relations*, A Study prepared for the Royal Commission on Dominion Provincial Relations, (Ottawa: 1939).

a continuing boom which foster over-ambitious programmes of road-building, irrigation projects, and electrification sometimes are overlooked. These credit-rating agencies adjust their ratings more on the basis of cyclical, industrial movements than on strict financial grounds.

4. <u>What is the loan for?</u>

Generally speaking, loans for capital purposes with a readily identifiable purpose and rate of return over a specific pay-back period are preferred to 'soft loans' used to finance ongoing programmes. Thus financing capital projects are preferred to financing operating expenditures. Hence the outrage expressed by the financial community in the 1930s over deficits being contracted to pay out 'dole' to the unemployed. This opposition is especially acute for local and provincial governments that do not have access to the printing press. This antipathy against dole was championed by the financial press and business leaders who earnestly believed that relief payments were subverting the work ethic and would lead to the erosion of economic self-reliance.

5. <u>What is the term of the loan?</u>

The borrower is likely to find that the term of the loan is the subject of intense negotiations. As a rule, the longer the term, the higher the yield expected by the investor for the future course of bond and commodity prices is always filled with uncertainty. If funds are advanced for *capital* purposes, the most common procedure is to *match* the term of the loan to the expected life of the capital asset. For instance, should a state wish to borrow funds to erect a new state university, the life expectancy of the campus would be 50 years or longer. Therefore the borrower would seek out lenders willing to advance the sums required for a period of 50 years. In the area of public utility financing, borrowing for 20 to 35 year terms is common with payment often "secured" by long-term hydro export contracts payable in the creditor's currency.

There is some reluctance by institutional investors to purchase long-term bonds to finance the immediate operating costs of government departments. Normally the view taken is that such temporary deficiencies are properly financed by short-term bank borrowing rather than by an issue of long-term bonds.

6. <u>Is there provision in the loan agreement for a sinking fund?</u> [882]

Sinking or purchase funds are frequently set up by municipalities when issuing debt. Here the borrower agrees to establish a sinking fund usually managed by an independent board of sinking fund trustees, who are required to purchase annually a portion of the outstanding debt. This means that by the maturity date the debt outstanding in the hands of the public will be much smaller than the original amount issued. As a consequence, the investor will be more confident in expecting receipt of the principal at maturity date. Further, the very existence of the sinking fund provision in the loan covenant ensures that the sinking fund trustees will be active in the market buying the debentures so the buyer may be reasonably sure that he/she will be able to unload the bonds.

Although the Dominion's *Consolidated Revenue and Audit Act, 1931* and the *Financial Administration Act* make provision for a sinking fund, this option has rarely been used.[883] The Government, through the central bank, operates a purchase fund whose operations came under considerable scrutiny during the 1958 refunding operations. Currently government purchases of bonds are relatively insignificant representing about one per cent of the outstanding debt.

7. <u>Does the security carry a call feature?</u>

We have already noted the main characteristics of the call feature being advantageous to the issuer but being vigourously resisted by the lenders. This resistance translates into initially higher yields to the investor yet provides the borrower with a measure of flexibility when interest rates fall. When interest rates rise the debtor is able to defer refinancing until the final maturity date while continuing to pay interest at the original, lower rates for the period beyond the call date.

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[882]See W.T.G. Hackett, "Sinking Funds in the Canadian Capital Market," in J.F. Parkinson (ed.), *Canadian Investment and Foreign Exchange Problems*, (Toronto: 1940), pp. 204-212.

[883]In 1959 and 1960 the Government guaranteed C.N.R. debentures with sinking fund provisions.

APPENDIX B. Glossary of Financial Terms

Amortization. The writing off of expenses associated with a bond issue. Expenses include: bond discount, commissions, advertising, prospectus.

Bank Rate. The minimum rate at which the chartered banks and Quebec savings banks may borrow from the Bank of Canada.

Basis Point. One one–hundredth of one per cent. A term frequently used to characterize "spreads" between different types of securities.

Bearer Security. A security not recorded in the books of the corporate or governmental issuer, i.e. not registered. It is therefore negotiable by the holder, the holder presumed to be the owner of the security.

Bond. Evidence of a debt usually on elaborately engraved fine paper difficult to forge, which represents a promise to pay the bearer a stated amount on interest over a specified period and to repay the principal on the maturity date. In theory "bonds", as distinct from "debentures", are pledged against assets of the firm or government i.e. first mortgage bonds.

Broker. A financial intermediary that acts as an agent on behalf of a client. Brokers do not purchase bonds for inventory purposes but rather facilitate the transfer of securities from one holder to another.

Call feature. Gives the issuer the opportunity to call in or redeem the issue after a specified date at a certain price with appropriate notice to the holders.

Commission. A fee charged by a bank or an investment dealer for buying or selling securities on behalf of their clients.

Coupon. A piece of finely engraved paper attached to a bond on which is printed the amount and date this interest coupon may be cashed. The holder of the coupon is assumed to be the rightful owner.

Coupon Rate. The rate of interest payable which is set out on the front of the bond. A bond with a coupon rate of 10 per cent sold at 99.75 will yield slightly over 10 per cent. However, the holder will only receive the indicated coupon rate.

Debenture. A security evidencing indebtedness to the holder of a debt against which no specific assets are pledged.

Default. When the debt issuer fails to meet interest payments or is unable to pay back the principal on maturity, the bonds are said to be "in default."

Discount. The amount a bond is trading below par or 100. Newly issued bonds may be sold at a discount, that is below par.

Exempt Institutions. Category of institutional investors offered securities by an underwriting group on behalf of the whole group.

Face Value. The value of the bond that appears on its face including the currency payment is denominated in. This is ordinarily the amount the issuer promises to pay the holder upon redemption at maturity date.

Firm Bid- Firm Offer. An undertaking to buy (firm bid) or sell (firm offer) a specified debt instrument at a specified price. There is an undersatnding that unless the other party to this verbal agreement releases the other party, the trader must honour the arrangement.

Fiscal Agent. An investment dealer, bank or trust company which is responsible for managing new and outstanding securities and handling the mechanical aspects of

record-keeping, payment of interest, and redemption of securities.

Jobber. An investment dealer that takes into inventory bonds of a certain issuer or maturity range and is ready to buy and sell, to "make a market" in that particular segment of the market. The jobber with expert knowledge of the value of the securities tradedimproves the functionning of the market by helping to smooth out short-term price fluctuations.

Liquidity. The proximity of a debt instrument to the redemption date.

Long Position. A financial intermediary has purchased these securities and taken them into inventory. These securities will be disposed of a market conditions dictate.

Longs. Bonds with a term to maturity over 15 years.

Market Price. The last price at which a security was traded.

Marketability The ease with which a bond can be bought or sold. City of Victoria bonds are less marketable than Ontario Hydro bonds for instance.

Money Market. That part of the capital market in which short-term, fixed income assets are traded. Securities traded include treasury bills, bankers' acceptances, commercial paper and other securities with a maturity of less than three years.

Over-the-Counter-Market. Market for securities composed of dealers who may or may not be members of a recognized stock exchange. The capital market is an over-the-counter-market linked by telephone connections in which transactions are arrived at by mutual agreement.

Premium. The amount by which a preferred stock or debt instrument may sell above the issue price.

Primary Distribution. The original sale of company or government debt or equity capital.

Primary Distributor. A broker, investment dealer, or bank which is an authorized distributor of Government/Dominion of Canada bonds. The allotment of bonds to these primary distributors is based on past distribution records although some more subjective considerations may come into play.

Principal. An investment dealer that purchases securities for the account of the firm, not for a client.

Prospectus. A legal document prepared for the investing public setting out the terms and conditions of the security to be issued as well as details relating to the financial condition of the borrower. Canadian governments are not required to issue a prospectus, but were required to file a shortened prospectus under the Securities and Exchange Commission regulations beginning in 1933.

Registered Security. Security recorded on the books of the issuer in the name of the owner and can only be transferred when endorsed by the registered owner. Securities may be fully registered (principal and interest) or registered as to principal only.

Secondary Market. Capital market in which trading of securities previously distributed takes place. The value of traded securities gives the issuer a ready gauge as to the yield presently demanded by the market participants for securities of a particular term.

Spread. Frequently used to indicate the difference between long-term and short-term yields or between the yields of similar Canadian and U.S. federal securities. Also relates to the difference between what a deposit-accepting institution pays for its money and what the institution earns.

Sinking Fund. A fund established to buy for redemption outstanding securities of the

issuer over a period of time to facilitate meeting final principal payments.

Tap Loan. A loan which is offered over a period of months, perhaps up to a year at a set rate like the initial sales of Canad Savings Bonds. A normal distribution would involve an initial offering, the opening of the subscription books which are then closed in several days or several hours.

Tranche. Term to maturity of an issue. A bond sold maturing in 12 years is said to be issued in a 12 year tranche. Frequently an offering by the Bank of Canada will be in several tranches, for example a seven year tranche (medium term) and a 30 year tranche (long term).

Treasury Bills. A short-term obligation of governments (usually 90 to 365 days) sold to institutional investors primarily at a discount maturing at par or 100. The difference between the discounted price and par value represents the creditor's reward and is regarded as interest income for taxation purposes.

Underwriter. A dealer usually with the financial backing of a bank which agrees to purchase the issuer's bonds at a specified price normally set just prior to the distribution of the securities.

Yield. Return on investment. For a bond the yield is arrived at by taking into account the price paid, time to maturity, and the coupon rate of the instrument. A bond which is purchased at a discount will yield a higher return than the coupon rate because of the capital gains at maturity and the price paid. A bond purchased at a premium will yield the holder a rate below the coupon rate.

APPENDIX C. Chronology of Events

July 28 1930– R.B. Bennett's Conservatives rout King's Liberals.

Autumn 1930– Markets nervous with prospect of major Latin American defaults.

October 1930– Negotiations fall through with Gundy over forthcoming conversion loan.

May 8 1931– Bennett announces massive Conversion Offer.

September 21 1931– England abandons gold. Bond prices fall dramatically.

October 17 1931 Order–in–Council passed allowing banks to write–up securities' values

October 19 1931– Gold redemption under Finance Act suspended.

November 1931– National Servive Loan raises $100,000,000

July 1932– World Monetary Conference pledges to brings interest rates down.

October 1932– W. Clifford Clark appointed Deputy Minister of Finance.

January 5 1933– U.S. Congress revokes the gold clause.

March 21 1933– Rhodes budget proposes new tax on foreign holders of Dominion bonds. Markets react negatively.

May 1 1933– Savings deposit rates at banks lowered to 2.5%.

July 1 1933– C.C.F. born issues manifesto calling for nationalization of financial institutions.

July 31 1933– Bennett announces appointment of Royal Commission on Banking and Currency.

September 1 1933– London borrowing operation well received.

September 1933– Royal Commission reports.

November 1933– Report made public, Bennett promises to create a central bank

February 1934– Bank of Canada Act introduced.

July 4 1934– Bank of Canada Act given royal assent.

August 1934– Fortnightly treasury bill auction instituted.

September 1934– Negotiations completed to drop bank deposit savings rate to 2%, Towers appointed Governor, Bank of Canada.

March 10 1935– Bank of Canada opens for business.

April 1935– Hepburn repudiates hydro contracts with four private Quebec power companies.

June 1935– U.F.A. Government appeals to central bank for aid to finance road–building.

August 22 1935– Social Credit League wins landslide– first Social Credit Government in world.

September 1935– Loan provided to Alberta by Dominion to meet basic expenses of the new government.

October 14 1935– King sweeps back into power on slogan "King or Chaos".

April 1 1936– Alberta defaults on $3,500,000 in principal payment.

May 30 1936– By Order-in-Council interest on Alberta's bonded indebtedness cut in half.

August 1936– Dated stamp scrip programme launched.

September 1936– $55,000,000 issue of perpetuals marketed to yield 3.11%

December 1936– Vernon Knowles appointed "Public Relations Advisor" to the Canadian Bankers' Association.

February 1937– Charles Cockcroft, Alberta Provincial Treasurer resigns. Reduction and Settlement of Debts Act ruled *ultra vires.*

April 1937– Alberta introduces programme of bank taxation

May 1937– Dominion Conversion Loan retireslast of the tax exempt bonds issued during the Great War.

September 1937– Several Alberta acts reserved

June 8 1938– Saskatchewan general election, King completes nationalization of Bank of Canada.

June 15 1938– Various debt reduction acts disallowed.

October–November 1938– Discussions between Bank of Canada and IDA and CBA over a new distribution procedure.

November 15 1938– $40 million (U.S.) encounters market nervous over the "European situation".

April 25 1939– Dunning budget– introduces tax credits for capital expenditures.

September 10 1939– Canada at war with Germany

September 12 1939– Ilsley introduces "pay as you go budget".

October 4 1939– Further Alberta debt adjustment acts disallowed.

November 24 1939– Working Committee, Dominion of Canada Financing reports. Recommends all-out marketing effort.

January 15 1940– First War Loan offered.

May 16 1940– Rowell–Sirois Report tabled in House of Commons.

September 9 1940– Second War LOan offered.

March 26 1940– Liberals returned to office.

March 1941– National War Finance Committee established

April 20 1941– Hyde Park agreement reached.

April 29 1941– Ilsley budget –withholding tax announced, subsequent modified.

June 2–21 1941– First Victory Loan campaign.

October 18 1941– Government introduces comprehensive plan of price controls.

December 7 1941– Pearl Harbour attacked by Japanese, U.S. enters war.

January 1 1942– War Savings Committee abolished.

March 27 1942– Three Alberta acts disallowed.

April 27 1942– Plebescite releases Government from conscription pledge.

April 1942– Second Victory Loan campaign.

June–July 1942– Discussions with banks on deposit certificates

October 19–November 7 1942– Third Victory Loan campaign.

January 15 1943– New York financing raises $90,000,000 in three tranches.

April 26–May 5 1943– Fourth Victory Loan campaign.

August 4 1943– Drew wins Ontario election with 38 seats, C.C.F. second with 34 seats, Liberals reduced to 15.

August 9 1943– Liberals trounced in 5 by–elections with C.C.F. gaining 3 western seats.

October 18–November 6 1943– Fifth Victory Loan campaign.

January 27 1944– Speech from the Throne promises old age pensions, family allowances, and improved veterans' benefits.

February 8 1944– Bank rate dropped to 1.5% from 2.5%.

April 24–May 13 1944– Sixth Victory Loan campaign.

June 15 1944– First social democratic government elected in North America.

July 11 1944– Ilsley Budget offers "benign" interpretation of mounting national debt.

October–November 1944– Conscription crisis.

October 23–November 11 1944– Seventh Victory Loan campaign.

April 12 1945– *White Paper on Employment and Income* tabled by Howe in House of Commons.

May 8 1945– V–E Day.

June 11 1945– Liberals returned in general election.

September 3–6 1945– Keynes visits Ottawa to arrange a loan.

June 26 1946– First issue of Canada Savings Bonds announced, $467 million sold in first year "on tap".

July 1 1946– Canadian dollar pegged at $1.00 U.S.

December 5 1947– Exchange Crisis breaks– Proposed Eximbank Loan announced by Abbott in Commons.

December 16 1947– Foreign exchange conservation measures announced by Abbott.

January 1948– Secret meeting between Minister and Bank of Canada officials– agreement to allow bond prices to move upward.

June 27 1949– St. Laurent leads Liberals to victory.

September 19 1949– Canadian dollar devalued by 10 per cent.

June 1950– Korean War commences– heavy inflow of U.S. dollars

September 5 1950– Abbott Budget raises taxes as part of Government's anti-inflationary programme.

October 2 1950– Canadian dollar unpegged, floats upward.

October 17 1950– Bank rate raised to 2 per cent.

February 1951– Banks agree to scrutinize credit applications more rigorously.